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I. Introduction

The income tax status of damage awards in personal injury actions assumes greater importance as litigation in this area increases and the monetary value of judgments and settlements escalates. If the United States experience has any predictive value for Canadian trends, the statistics are ominous indeed. During the last decade alone, medical malpractice cases, which represent but one segment of personal injury actions, have witnessed an increase in the average quantum of damages from $62,151 to $350,000, while the total payout in New York State went from $1.4 million to $17 million.[1] If, as Street had commented, ". . . the importance of a topic is to be judged by the number of writs issued, then actions for personal injuries are as important as any legal topic today . . ."[2] — perhaps more so in 1976 than in 1962 when the observation was made.

At the same time, the doctrinal treatment of tax considerations differs markedly between Canadian, English and American jurisdictions. In Canada, since the Supreme Court's decision in *R.* v. *Jennings,*[3] a judicial tribunal is not required to account for income tax factors in the determination of the quantum of damages in such actions. The Court reasoned that compensation in personal injury actions replaced impaired capacity rather than earnings, and was perturbed by the pragmatic hurdles to a deliberative consideration of tax factors. Further, whether or not the right to sue for damages for personal injury constitutes a "chose in action" and therefore "property" under the capital gains provisions has not been settled.[4]

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1. "The Doctors' New Dilemma", *Newsweek*, February 10, 1975.
2. H. Street, *Principles of the Law of Damages* (London: Sweet & Maxwell Ltd., 1962) at 43.
3. *R.* v. *Jennings,* [1966] S.C.R. 532; 57 D.L.R. (2d) 644, *aff'g* (*sub nom. Jennings* v. *Cronsberry*) [1965] 2 O.R. 285; 50 D.L.R. (2d) 385 (C.A.).
4 Compare *McCormack* v. *Toronto R. W. Co.* (1907), 13 O.L.R. 656 (D.C.) and

The English, in direct contrast, consider income tax factors in assessing the quantum of an award, on the authority of the House of Lords in *BTC* v. *Gourley*,[5] on the premise that a component element of such awards represents a substitution for lost earnings, which would normally be taxable. The American stance, which chronologically preceded both the Canadian and English resolutions, favours non-taxation, but achieves this objective by virtue of a statutory provision, supposedly founded on a replacement of capital argument.[6] However, although the *Code* specifically exempts such awards from taxation, the consideration of income tax factors in assessing the quantum of an award has found a varied response in the American courts.[7]

These differences provide cause for concern; for while every jurisdiction is sovereign in enacting its taxing statutes, concepts such as income and damage theory have, at least, a common lineage in the common law world. The purpose of this paper is to examine these differences in both the tax treatment of damage awards in personal injury actions and the consideration of income tax factors in assessing the quantum of such awards.[8] It is suggested that part of the confusion results from a myopic view of income tax as a separate and distinct branch of the law, isolated from all other segments of law. The problem was considered by both the English and Scottish Law Reform Committees,[9] which failed, however, to reach any conclusion, and suggested further review in the future. Again, academic writers have tended to concentrate on the pragmatic rather than the conceptual hurdles encountered, and have focused on isolated pockets.[10] The problem is further aggravated by the tendency of most decisions to state the result rather than to

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Re Hollister (1926), 30 O.W.N. 328 (Bankruptcy Ct.) with *Curtis* v. *Wilcox*, [1948] 2 K.B. 474 (C.A.) and *DiGuilo* v. *Boland* (1958), 13 D.L.R. (2d) 510 (Ont. C.A.).

5. [1956] A.C. 185; [1956] 2 W.L.R. 41; [1955] 3 All E.R. 796 (H.L.).

6. Section 104, *Internal Revenue Code*. The long history of departmental rulings holding personal injury recoveries non-taxable, on the theory that they roughly correspond to a return of capital, may be found in: 2 Cum. Bull. 71; I-1 Cum. Bull. 92, 93; VII-2 Cum. Bull. 123; 1954-1 Cum. Bull. 179, 180.

7. *Infra* at 418 *et seq*.

8. In this paper the use of the phrase "tax treatment of damage awards" is intended to apply to application of taxes by the appropriate administrative agency, *e.g*. DNR in Canada. The phrase "tax factors" refers to the consideration of taxes by *the court* in assessing damages.

9. The English Law Reform Committee, 7th Report (1958; Cmnd. 501); the Scottish Law Reform Committee 6th Report (1959; Cmnd. 635).

address the underlying conceptual issue of whether the damage award, or any part thereof, represents compensation for capacity or loss of earnings. Throw into the pot terminological licence to interchange descriptive titles, and one is left with a stew of incongruous conclusions.[11]

The approach adopted in this paper is a search for a satisfactory resolution, which necessitates an analysis on a conceptual plane of the theories of income and damages, and a reconciliation of these theories with the articulated objectives of a tax system. Pragmatic and administrative considerations which influence any tax system are then considered on the basis of the conceptual foundation. Hence, the initial examination focuses on the theory of income and the objectives of a tax structure, whence it proceeds to an analysis of the underlying precepts of damage determination. Finally, upon analysis of these foundations, the focus shifts to specific proposals for the pragmatic integration of these segments in the Canadian context.

In devising the specific proposals for reform, the emphasis remains on conceptual integration, with any necessary sacrifices dictated by pragmatic considerations being confined to the essential minimum. Thus, the underlying philosophy is that conceptual purity should only be sacrificed *after* a rigorous evaluation of the reasons necessitating the sacrifice, with consciousness of the resultant costs and the corresponding benefits derived. While the scope of the topic discussed in the pages following is relatively narrow, the expectation is that the overall approach may serve some wider purpose in Canadian tax circles. Hence at one level, the methodology of the analysis presented may have application in actions for wrongful dismissal, invasion of privacy, strike pay and the treatment of collateral income and benefits. Questions as to whether payments for wrongful dismissal constitute income

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10. G. Dworkin, *Damages and Tax — A Comparative Survey,* [1967] Bri. Tax Rev. 315 at 320:

> . . . In order to analyze these matters properly it would be necessary to examine all the cases dealing with the taxation of compensation awards and also to embark on the wider problems of capital and income. That is beyond the scope of this article . . . .

11. The terminology employed to express notions of capacity and earnings is extensive. Phrases such as "impaired capacity", "capital asset", "replacement of capital", "loss of earning capacity", "loss of earnings", "capacity to earn" are illustrative of judicial usage.

continue to elicit responses predicated on the form of drafting, rather than on any conceptual foundations.[12] On a broader spectrum issues of conceptual tax development, equity and sacrifices to administrative convenience and simplicity are constantly recurring problems.

II. Theory of Taxation

In attempting this conceptual reconciliation, one may start with an examination of the theory of taxation. The exposé of this theory may be enhanced if two aspects are segregated and analyzed distinctly. On the one hand is the question of the objectives of a tax structure. On the other hand, there are issues which relate to the concept of income. Taken together, the two should amalgamate into a cohesive theory of taxation. The problem, however, is not one that is merely restricted to the development of a theory of taxation, but is influenced by one's attitude toward that theory. Hence, it is suggested in this context, that one should start with the concept of an "ideal" structure and examine its underlying purpose to extract its *raison d'être*. At a later stage one may compromise this "ideal" structure in the interests of pragmatic necessity, recognizing that we depart from the ideal at a cost of conceptual purity, in order to receive in return efficiency of administration and the efficacy of implementation which represent benefits. Thus, here as elsewhere in this paper, the task is to develop a theory with conceptual purity, and at a later juncture to sacrifice a part of this purity, which sacrifice involves a cost or detriment, in order to enhance administrative convenience which implies a benefit. At all stages, then, it remains important to evaluate the relative cost (detriment) involved in the sacrifice and the resulting benefit derived from that sacrifice.

1. Objectives of a Tax Structure

In order to evaluate the various and oft times conflicting objectives of a tax structure and determine the relative weight to be assigned to conflicting objectives, one may ask: Why have an income tax at all? For in the answer to this question lies embedded the solution as to the weight which should be attributed to conflicting objectives. It is

12. Compare *R.* v. *Atkins,* [1975] C.T.C. 377 (F.C., T.D.), *aff'd* (1976), 76 D.T.C. 6258 (F.C.A.) with *Quance* v. *The Queen,* [1974] C.T.C. 225; 74 D.T.C. 6210 (F.C., T.D.).

submitted that the answer to the question posed is *not* the raising of revenue as being the primary objective of a tax system. For, as the Carter Commission[13] observed, if that were the primary objective, any government might, in order to raise revenue, resort to commandeering resources. This technique, however, would usually be inefficient if done fairly, and otherwise tend towards capricious results. Alternatively, the government could create money. Such a route would, however, tend to inflame inflation if done without any increase in national output, when all resources were productively employed. The consequences of this method would be to penalize those residents who were on fixed income and cause them to carry a disproportionate burden.

To thwart the possibilities of such adverse consequences, a government might resort to compulsory payments as a means of transferring resources from private to public hands, a system otherwise known as taxation. Within this generic category, however, are available several diverse forms of taxation, each method attended by different consequences. Thus, a property tax may penalize only one segment of society for benefits provided to all. A sales tax may have the effect of unduly burdening those at the lower income levels, who proportionately are required to consume a larger percentage of their income, thereby in effect becoming a tax on consumption.

A further alternative, and the one adopted by the three jurisdictions which are within the concern of this paper, is the implementation of an income tax. Although an income tax presents possibilities of the tax being shifted down into the price of goods, such taxes can at least reflect an equitable intention. As the Carter Commission observed:

> . . . if a government had to choose one method to the exclusion of all other methods, taxation would be preferable because it *can* be more equitable, *can* be less disruptive to the economy, and *can* give the government more effective control over the total demand for goods and services [emphasis in original text].[14]

Again, in discussing the objectives of a tax structure, the Commission cited, *inter alia,* the maximization of current and future output of goods and services, and ". . .[t]o ensure that this

13. 2 *Report of the Royal Commission on Taxation* (Ottawa: Queen's Printer, 1966) at 2 — "Carter Report" [hereinafter "Carter Report"].
14. *Id.* at 4.

flow of goods and services is distributed equitably among individuals or groups. . . ."[15]

The recognition of the importance of equity as a determinant of a "good" tax structure is certainly not a novel suggestion, though as an objective it suffers from a remarkable propensity towards asphyxiation by tax legislation. Adam Smith early supported the notion of taxation according to ability to pay, and the importance of equity in taxation, when he postulated:

> The subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their several abilities . . . In the observation or neglect of this maxim consists the equality or inequality of taxation.[16]

In a similar vein these sentiments were echoed by the Carter Commission in its comprehensive review of the Canadian tax structure. In directing its attention to the issue of the approach towards equity in tax structures, the Commission recommended that ". . . the government must seek to impose progressive marginal tax rates on *all* additions to personal economic power, *without regard to the source of those increments in power* . . . It should also be a goal of the tax system to avoid tax concessions to particular industries and *to particular kinds of income* . . . ."[emphasis added].[17] However, as will be demonstrated later, the imposition of a marginal rate progressively linked to income levels, designed as a vehicle to achieve equity, may result in inequitable results if indiscriminately applied and without the implementation of special ameliorating provisions.

In addition to the objectives of equity and revenue generation, several other objectives have their influence within an "ideal" tax structure. Hence, in order to facilitate the implementation of the system it is desirable to minimize the administrative problems and the associated costs of collection. Every tax ought to be such that its cost of collection may be reasonable. This objective is implemented by the imposition of a "simple" tax system, one designed to minimize the problems associated with measurement and quantification. The influence of this objective may be seen in the selection of a calendar year as the yardstick for the measurement of income. Any conceptual definition of income in terms of accretion of wealth

15. *Id.* at 7.
16. Graham, ed., *The Synthetic Wealth of Nations* at 282.
17. *Supra*, note 13 at 10-11.

must be tempered with the associated problems of measurement in accounting. As Dickinson has commented:

> Inasmuch . . . as the ultimate realization of the original investment is from the nature of things deferred for a long period of years, during which partial realizations are continually taking place, it becomes necessary to fall back on estimates of value at certain definite periods, and to consider as profit and loss the estimated increase or decrease between any two such periods.[18]

Inherent in the selection of an accounting period such as a calendar year, and the concept of realization, is the recognition of a sacrifice of conceptual purity in the definition of income in favour of an enhancement of administrative simplicity.[19]

Given these diverse objectives of an "ideal" tax structure, conflict is inevitable and compromise becomes imperative. In evaluating conflicting objectives and the relative weight to be assigned to each, one is compelled — indeed it is inescapable — to reflect value judgments premised on some explicit or implicit ideology. The leaning of this writer is that equity should play a pre-eminent role within the structure, given that the existence of the structure itself presupposes the need for revenue generation, and that this latter objective is implicitly recognized once a tax system is brought into existence.[20]

2. *Structural Foundation of Income Tax*

In part the definitional problem of identifying income is inextricably linked with the problem of identifying the objectives of a tax structure. The interdependence of the conceptual notion of income with the objectives of a tax structure combine to answer the question: What is income? Hence, Simons in his classic work

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18. A.L. Dickinson, *Accounting Practice and Procedure* (New York: Ronald Press Co., 1918) at 67.
19. Other objectives cited for an ideal tax structure include the need for certainty and convenience. Further, a taxing statute may be used as a vehicle of socio-economic policy. Illustrations founded on socio-economic policy, as opposed to the structural concept of income, may be seen in s. 38 (capital gains taxed at half rates in effect); s.110 (1) (a) (deductions pertaining to charitable donations); s. 63 (child care deductions); s. 20 (1) (a) (accelerated capital cost allowances); s.125 (1) (small business deductions for CCPC); all in the *Income Tax Act*, S.C. 1970 - 71 - 72, c. 63.
20. A similar emphasis was adopted by the Carter Commission. ". . .[W]e are convinced that unless this objective i.e. equity is achieved to a high degree all other achievements are of little account . . . .", 2 Carter Report, *supra*, note 13 at 17.

embarks on the definitional problem with explicit assumptions in regard to the objectives of a tax structure, and emphasizes the role of equity:

> . . . Income taxation is broadly an instrument of economic control, a means of mitigating economic inequality . . . . We shall assume the moderation of inequality is an important objective of policy and proceed to consider income taxes as devices for effecting it . . . .[21]

In a sense then, it may be suggested that the *sine qua non* of "income" as a definitional term is the presupposition of the desirability of equity. As Simons puts it: ". . . Since it is widely agreed that income is a good tax base, its meaning may be sought by inquiring what definition would provide the basis for most nearly equitable levies . . . ."[22]

Given his explicit acceptance of equity, he proceeds on the premise that any concept of income should satisfy the requirements of objectivity and quantifiability: ". . . It must be measurable; indeed, definition must indicate or clearly imply an actual procedure of measuring . . . ."[23] While such requirements may not be conceptually necessary in any abstract sense, it is difficult to fault his pragmatic premise. Proceeding on the foundation of the above, he suggests a concept of income related to the accumulation and/or consumption of wealth over some period of time. In conventional mathematical symbolism:

$I = W_{t+1} + C - W_t$ (Where I = income during a period of time

C = the market value of rights exercised in consumption

W = person's store of property rights

t = appropriate time interval)

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21. H. Simons, *Personal Income Taxation* (Chi., Ill.: U. of Chicago Press, 1938) at 41.
22. *Id.* at 42.
23. *Id.*

In this context then, the span assigned to "t" may range from a day to a lifetime, with the resolution dependent upon pragmatic rather than conceptual considerations. The essence of the concept is thereby reduced to gain during an interval of time — ". . . The *sine qua non* of income is gain, as our Courts have recognized in their more lucid moments — and gain to someone during a specific time interval . . . ."[24]

Other classical definitions of income, albeit not identical, have pursued a similar path and aligned themselves with the concept of the creation of wealth. Thus, Haig conceptualized income as ". . . the money value of the net accretion of economic power between two points in time . . . ."[25] So also Fisher conceived of income as ". . . a flow of benefits during a period of time . . . ."[26] Again, Marshall, when he observed that income should include imputed income, preferred the all-inclusionary approach — "For scientific purposes, it would be best if the word 'income' when occuring alone should always mean total real income."[27]

Several observations may be extracted from these views of income as formulated by the classical economists:

(i) there is conceptual similarity, if not identical concordance, in the views of these various economists, defining income as an accretion to wealth, whether it be in terms of benefits received, a flow of satisfactions or the inclusion of imputed income;

(ii) the time interval "t" is left open in any definition of the concept of income. At its maximum it would include a lifetime;

(iii) no mention or emphasis is placed on the notion of realization of benefits in order for its inclusion into the embrace of income.

Notwithstanding the inherent appeal of conceptual purity, one recognizes the pragmatic limitations generated in the implementation of a "pure" doctrine from an administrative viewpoint. Any such doctrine must be capable of withstanding the rigorous test of day-to-day administration by the taxing authorities and judicial

24. *Id.* at 50.
25. R. Haig, *The Concept of Income, The Federal Income Tax* (Columbia U. Lectures: Columbia U. Press, 1920).
26. I. Fisher, *Elementary Principles of Economics* (New York: Macmillan, 1919) at 60.
27. A. Marshall, *Economics of Industry* (London: Macmillan & Co., 1893) at 67.

determination resulting from inevitable conflict situations. One may echo the sentiments of the Carter Commission that the problem is thereby reduced to one of specifying a tax base that ". . . maintains the integrity of the concept without creating insuperable administrative difficulties . . . ."[28]

These administrative and pragmatic hurdles were not unknown to the earlier classical writers. Simons himself was not unaware of the problems inherent in his definition when he asked where the line was to be drawn between economic and non-economic activity. In this context, Kleinwächter posed a few interesting conundrums:

(i) Do families have larger incomes because parents give competent instruction to children instead of paying for institutional training? Does a doctor have relatively large income in years when his family requires and receives an extraordinary amount of his own professional services?

If such amounts were included, we might be able to demonstrate that poverty level families actually had substantial incomes if account were taken of necessary services internally performed rather than externally purchased.

(ii) What of the problem of leisure? Is leisure, beyond a certain minimum, itself an item of consumption? As Kleinwächter noted ". . . A little reflection along these lines suggests that leisure is itself a major item of consumption; that income per hour of leisure, beyond a certain minimum, might well be imputed to persons according to what they might earn per hour if otherwise engaged. . . ."

(iii) What of compensation in kind? Here he asked ". . . how would one measure the relative incomes of an ordinary officer serving with his troops and a *Flügeladjutant* to the sovereign? Both receive the same nominal pay; but the latter receives quarters in the palace, food at the royal table, servants, and horses for sports. He accompanies the prince to the theatre and opera, and, in general, lives royally at no expense to himself and is able to save generously from his salary. Then again, suppose the *Flügeladjutant* detests opera and hunting. . . .[29]

Such problems, while they detract from the administrative feasibility of enforcement, are inherent in the "economic power" concept of income. However, they are not completely and totally insuperable, as was demonstrated by the Carter Commission in its

28. 3 Carter Report, *supra*, note 13 at 22.
29. Kleinwächter, *Das Einkommen und Seine Verteilung* (1896) at 1-16.

formulation of a "comprehensive tax base". The problem then may be reduced to a dual dimensional conflict. At one level there is the conflict between the various objectives of a tax system, with particular tension between equity on the one hand and simplicity and administrative feasibility on the other. On another level, there is the conflict of conceptual purity in a doctrine of income, which stands at the core of the structure, and the necessity for simplicity and administrative convenience. The question becomes: How much impurity will we permit in the interests of pragmatic necessity and the pursuit of administrative convenience, and still remain within the realm of an equitable tax structure?

Before answering this question, it may serve some useful purpose to examine some major concessions made to administrative considerations, and presently embodied within the Canadian tax system. One such concession is the concept of realization. Thus a gain is not subject to taxation until the gain has been realized. The rationale for this rule is not that there has been no income generated in any economic sense, but rather because of the difficulty of valuation without a market transaction.[30] The economic concept of income as an accretion to wealth is thus diluted in favour of administrative necessity. Again, imputed income, *e.g.* from the imputed rent on an owner-occupied residence, is not brought into the computation of income, not because of any rationale inherent in the definition of income but again in deference to problems of valuation and administration. Similar reasons may justify the exclusion of various benefits observed in Kleinwächter's conundrums.

When one turns to the choice of an appropriate time interval, denoted by "t" in Simons' formulation of income, similar considerations prevail. The choice of a calendar year for the determination of the tax liability of an individual is premised on an artificial but convenient time horizon. While the accretion of wealth may occur over a shorter or longer period of time, it is considered convenient that an individual report his tax liability at discreet intervals of one year. This concession, coupled with the realization concept, results in the individual being liable for income gains

30. Section 5, *Income Tax Act* taxes income *received.* Section 38 requires a *disposition* for a capital gain or loss transaction. Problems of valuation do not explain the exclusion of unrealized gains where there is an active securities market, which permits accurate valuation. To explain exclusion in these circumstances, resort must be made to political and economic considerations.

realized during the calendar year. However, the cost of these concessions, made in the interests of administration, is the resultant sacrifice of equity, by permitting others to defer their unrealized gains, which would otherwise be included in an economic concept of income.

Each of the above-mentioned concessions, *viz.* realization, exclusion of imputed income, and the choice of the calendar year, is made from an administrative or other definitely specified objective, such as simplicity or socio-economic policy considerations. It is important then to realize, and for the courts and the taxing authorities to bear in mind, that when departure is called for from this economic concept of income, it is done for a specific purpose, and not because of an inadequacy of the concept itself, and that such departures are not justifiable when no specific benefit accrues which demonstrably outweighs the resulting cost of conceptual sacrifice of a fundamentally sound doctrine. Articulation of the rationale for departure from the concept becomes imperative.

Further, it is important to bear in mind that the concept of income is an *economic* concept, which has been modified by accountants and lawyers to meet the demands of specific situations, such as the requirements of a discreet and periodic time interval for financial reporting purposes, or the desirability of a market exchange transaction to enhance objectivity in financial statements.

The answer suggested in this paper to the question earlier posited about the necessary sacrifice of purity in favour of administrative convenience, is that the sacrifice of purity of the concept of income should be no greater than the *minimum* required to implement the proposal on an administratively feasible and cost conscious basis. Any sacrifice in excess of this minimum endangers equity as a primary objective of the tax structure, with no corresponding countervailing benefit. Hence, it is suggested that the following three questions should determine the tax treatment of damage awards:

(i) Does the damage award or any part thereof result in an improvement in the economic power of an individual, capable of objective measurement and quantification? If the answer is in the affirmative, then *prima facie* that *portion* of the award which causes the improvement in the economic power of the individual should be included in income, subject to the questions below:

(ii) Is it justifiable to treat the damage award in some special manner, due to the existence of particular circumstances surrounding its receipt which dictate its exclusion from income?

(iii) What will be the price paid by the tax structure in the event of exclusion from income, and with what resulting benefits? Unless the answers to the questions (ii) and (iii) produce a convincing rationale in favour of exclusion from income, the *prima facie* assumption of the first question should apply and the relevant portion of the damage award should be included in income, at least from the standpoint of an income theory.[31]

The distinguishing characteristics of the above suggested approach are at once its emphasis on equity as being a desirable and the primary objective of a tax structure, and a broad inclusionary concept of income premised on an accretion to wealth foundation. As Haig has observed:

> . . . It is very undesirable from the point of view of economics and equity that the judicial definition of income should develop along narrow lines by the process of definitely eliminating from the concept certain items as not being income . . . .[32]

The analysis following endeavours to analyze the character of a personal injury damage award in the context of the above discussed theory of income and taxation.

3. Damage Awards in the Context of Income Theory

The problem of identifying the nature of a personal injury damage award in order to determine its characterization as being an income item or in the nature of replacement of capital or some other form of hybrid is magnified by terminological misuse. As Street observes:

> Close scrutiny of Lloyd's List Law Reports, which report those parts of judgments dealing with damages more fully than any other series, reveals that the courts use the expressions "loss of earnings" and "loss of earning capacity" quite indiscriminately, as if nothing would depend on their choice.[33]

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31. The suggested approach in this paper is that only a *portion* of the total damage award should be subject to taxation. This portion will relate to the *earnings* component of the total award, as being embraced by the concept of income, and will exclude that portion of the award which relates to the loss of amenities of life, pain and suffering, *etc.*. The rationale for this approach is explained *infra* at 405 *et seq*.

32. *Supra,* note 25 at 27.

33. *Supra,* note 2 at 47.

This verbal misuse of phrases such as "loss of earnings" and "loss of earning capacity", together with the indiscriminate interchange of phrases such as "impaired earning capacity" and "replacement of capital" results, in part, from a lack of appreciation of the underlying theoretical premise. However, two major and diametrically opposed schools of thought emerge from the judgments and the literature in this subject area. On the one hand, there are those who suggest that a personal injury damage award represents replacement of a loss of earning *capacity*. This group may be categorized as the "capital asset" school, which favours non-taxation of *any portion* of the damage award recovered by the plaintiff, on the theory that such awards compensate for a loss of capacity or a capital asset, such items being considered non-taxable. At the present time, this view prevails judicially in Canada by virtue of the Supreme Court of Canada decision in *Jennings*. As Judson J. observed in his judgment: ". . . In a case of personal injuries, what the plaintiff has lost is the whole or part, as the case may be, of his natural equipment . . . ."[34] The United States has achieved the same result through statutory enactment of s. 104 of the *Internal Revenue Code*. On the other hand, there are those who favour the view that any such compensation received by the injured plaintiff represents in part at least a replacement of loss of earnings *per se* — both past and future — as opposed to earning capacity. This latter school argues that a portion of the plaintiff's damage award is granted "in lieu" of actual or potential earnings lost and may be characterized as the "substitution" school. This group would favour the taxation of that segment of the award relating to past and future earnings loss. However, differences of opinion exist within this latter group as to the mode of accounting for the tax element. The English, by virtue of the House of Lords' decision in *Gourley*,[35] adopted the approach that *the judicial tribunal* should adjust for tax factors, and reduced the plaintiff's pre-tax damage award of £37,720 (the portion relating to earnings only) to an after-tax amount of £6695. The thesis of this writer, for reasons explained later in this paper, is in favour of the Department of National Revenue taxing the appropriate portion of the plaintiff's award, on the authority of statutory enactment.[36]

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34. *Supra*, note 3 at 655.
35. *Supra*, note 5.
36. *Infra*, at 425 *et seq*.

If the capital asset theory is accepted, then it may be asked: What is the value of the capital asset that is being replaced? The answer would call for valuation of the capital asset as being the equivalent of the present value of future cash flows which are being compensated, at some specified rate of return. This method of capital asset valuation has wide application in other areas, *e.g.* where the capitalized value of an enterprise is computed for purposes of a sale transaction, the anticipated earnings flow may be discounted to their present value, in accordance with some specified rate of return; again the value of a bond is obtained by discounting the future interest payments plus the deferred payment of the principal sum, at the prevailing market rate of interest. The problem, however, in the context of personal injury damage awards, is to determine the underlying assumptions to which the method of valuation may be applied. Should the injured plaintiff have the capital sum of his compensation computed on the premise that he will or will not be required to erode his principal? The dilemma may be illustrated by examining the alternative techniques of computation premised on the two alternatives above mentioned. For the purpose of these computations, it is assumed that the plaintiff is injured in 19-0; trial of the action for damages is concluded by 19-2, at which trial expert testimony is adduced to show that the plaintiff shall have fully recovered by 19-5. His loss of earnings is established at $1000 *per annum,* and the prevailing interest rate is 5%.[37]

(a). No Erosion of Capital Required

Assuming that the purpose of any damage award recovered by the plaintiff is to compensate him for his pecuniary loss, in addition to any pain and suffering and medical expenses expended or to be expended, this plaintiff would need to recover that sum of money which would restore to him the $1000 annual loss suffered by him as a result of the assumed liability of the defendant. The plaintiff would establish loss as follows:[38]

37. The choice of a rate of interest may prove to be contentious. Options available are, *inter alia,* the prevailing prime rate at the date of trial, the yield rate of gilt-edge securities, the rate applicable to trustee investments. The selection of *any* of the above rates will provide a conceptually better result than the result which will be obtained by ignoring the discount factor entirely. Consideration of the selection of the "ideal" rate of interest is beyond the scope of this paper.

38. The theory and purpose of damage awards is considered *infra* at 408 *et seq*. At this juncture it is *assumed* that compensation is the primary objective.

Past Earnings Lost $2000
Future Earnings Sacrificed (Estimated) $3000

Presumably the plaintiff would be awarded $2000 for his actual past earnings loss, established as special damages.[39] Assuming that he is *not* expected to erode his capital sum, the plaintiff would need to be awarded $20,000 as representing the value of his capital assets designed to restore him to his pre-injury financial position.[40] If this prevailed the following would result:

Year	Capital Value at Start of Year	Interest @ 5%	Consumption at Pre-Injury Level	Capital Value at End of Year
19-3	$20,000	$1000	$(1000)	$20,000
19-4	20,000	1000	(1000)	20,000
19-5	20,000	1000	(1000)	20,000

In the above situation, the capital value would vary inversely with the rate of interest prevailing at the time of the award and expected to continue through the tenure of the plaintiff's disability. Thus, at a 10% rate of interest, the capital value required to produce $1000 annually would be $10,000; at 20% the requisite capital value would be $5,000.

The inherent flaw in this technique of computation is indubitable. The plaintiff would, under this method, enjoy not only compensation for his pecuniary loss, but would in addition derive a windfall profit at the end of his disability period, amounting to his enrichment. As Street has observed:

> Of course it is plain beyond doubt that a permanently incapacitated plaintiff is not entitled to that sum, interest from which would produce his lost earnings, for that would leave intact the capital at his death for the benefit of his estate.[41]

It is submitted that the above objection would apply with equal force to temporary injuries, as shown in the foregoing illustration. Given

39. It may be argued that the successful plaintiff should receive some compensation for the loss of use of his earnings for the past two years. The inclusion of some interest element would be conceptually desirable and computationally feasible.
40. The discussion here is concerned only with the portion of the total award related to pecuniary loss, represented by earnings. It does not involve consideration of the segment relating to pain and suffering, loss of amenities of life, medical expenses, *etc.*.
41. *Supra*, note 2 at 112.

the inherent disadvantage of this approach, it becomes imperative to require the plaintiff to erode his capital sum in order to prevent his enrichment at the expense of the defendant.

(b). Erosion of Capital Required

If one assumes the objective of damage awards as being for the *compensation* of the plaintiff, it becomes necessary to compute that component of the damage award relating to pecuniary loss in such a manner that a specified sum of money, invested at some specified rate of interest, will produce for the plaintiff, *when taken with capital erosion,* annual income commensurate with his pre-injury earnings, for some predetermined length of time (the period of injury or working life expectancy), such that the plaintiff is left with zero dollars of the *original* lump sum award at the end of the injury period or life.[42] This objective may only be attained by discounting to a present value the future cash flows lost by the plaintiff and implicitly requiring capital erosion. Without the mechanism of discounting, the plaintiff would remain subject to the criticism of enrichment discussed above, although the extent of his enrichment would be substantially reduced. Thus, in the context of the illustration above, if the plaintiff were awarded $3000 ($1000 p.a. x 3 years) for the future loss of earnings, the following would result:

Year	Capital Value at Start of Year	Interest @ 5%	Consumption at Pre-Injury Level	Necessary Erosion to Supplement Interest Earned	Capital Value at End of Year
19-3	$3000	$150	$(1000)	$(850)	$2150
19-4	2150	108	(1000)	(892)	1258
19-5	1258	63	(1000)	(937)	321

In this situation the plaintiff is enriched to the extent of $321 at the end of his injury period of three years, having received full compensation of $3000 for his future loss of earnings. Thus, the conceptual criticism of enrichment remains, albeit the magnitude of the problem diminishes.

42. It is recognized that absolute mathematical accuracy is not attainable in the computation of a damage award, in view of the number and complexity of the variables involved, *e.g.* the rate of interest, estimated years of injury, estimate of earnings, implied reinvestment at the original interest rate selected. However, *any* move in the direction of the concept suggested, even if intuitively, rather than mathematically applied, would enhance the desired objectives.

(c). Suggested Method of Computation

In order to eliminate, at least conceptually, the enrichment of the plaintiff, inherent in the above *methods* of computation, it becomes essential to account for the time value of money. Two different situations are encountered in this context:

(i) Temporary Injuries

Where the plaintiff has been temporarily injured and the period of his injury has been adduced by expert medical testimony, the underlying premise is that the plaintiff, having suffered an economic loss estimated at his years of reduced or total incapacity, should receive a discounted sum of money which, if invested at a specified rate of interest, and assuming capital exhaustion at the end of the injury period, will most nearly restore the plaintiff to his pre-injury status in any pecuniary sense. This sum may be computed from the following actuarial formula:

$$P = N\frac{(1 + r)^n - 1}{r(1 + r)^n}$$

Where: P = the present value of the lump sum
N = annual payment to the plaintiff
n = total number of years of expected incapacity
r = percentage investment rate

Continuing with the previous illustration, the plaintiff *should* be awarded a lump sum of $2724 in respect of his anticipated *future* pecuniary loss.[43] Given the lump sum award the following would result:

Year	Pre-Tax Capital Value at Start of Year	Pre-Tax Interest Earned @ 5%	Pre-Tax Consumption at Pre-Injury Level	Pre-Tax Capital Value at End of Year
19-3	$2724	$136	$(1000)	$1860
19-4	1860	93	(1000)	953
19-5	953	47	(1000)	0

Using the above computational technique, the injured plaintiff is restored to his pre-injury status during the tenure of his disability

43. $1000 $\dfrac{(1.05)^3 - 1}{(0.05)(1.05)^3}$ = $2724

and is *compensated* as opposed to enriched for his anticipated economic loss of future earnings.

A final consideration in the computation of quantum is the selection of the appropriate discount rate. Should the discount rate be applied on a pre-tax or net after-tax basis? In the preceding analysis the discount rate of 5 per cent was assumed to be on a *pre-tax* basis. Assuming further, that the plaintiff has a marginal tax rate of 50 per cent in the year of receipt of his damage award of $2724, and chooses *not* to make use of the forward averaging provisions suggested later in this paper, he would be left with a residue of $1362 on a net after-tax basis. Correspondingly reducing the pre-injury consumption level to a net after-tax basis of $500 per year, the following would result, if no further tax was levied on the interest earned:

Year	After-Tax Capital Value at Start of Year	Interest Earned @ 5%	After-Tax Consumption at Pre-Injury Level	After-Tax Capital Value at End of Year
19-3	$1362	$68	$(500)	$930
19-4	930	46	(500)	476
19-5	476	24	(500)	0

Thus, once again the plaintiff would be restored to his after-tax pre-injury level of earnings.

Where, however, the court applies an *after tax* discount rate of 2.5 per cent to the after-tax cash flow of $500 per year (assuming a marginal rate of 50 per cent), the plaintiff would receive $1428 as his award. *Implicit in this method,* however, is the assumption that the plaintiff would be taxed on his interest earned, and the following would result:

Year	After-Tax Capital Value at Start of Year	After-Tax Interest at 2.5%	After-Tax Consumption at Pre-Injury Level	After-Tax Capital Value at End of Year
19-3	$1428	$35	$(500)	$963
19-4	963	24	(500)	487
19-5	487	13	(500)	0

It is worthy of emphasis that the plaintiff, under either alternative, receives $500 per year on an *after-tax basis*. The difference of $66 ($1428 - $1362) may be explained in the method selected for the tax treatment of the interest component subsequent to the award. The pre-tax method assumes no further taxation of interest earned if the plaintiff elects to pay his tax lump sum. The after-tax method implicitly assumes subsequent taxation of the interest earned, by selection of an after-tax interest rate. Hence the difference may be explained as below:

Year	Pre-Tax Interest @ 5%	After-Tax Interest @ 2.5%	Difference
19-3	$68	$35	$33
19-4	46	24	22
19-5	24	13	11
			$66

The appropriate technique of discounting, in the context of the solution suggested in this paper, is discussed later.

(ii) Permanent Injuries

In a situation involving permanent injury to the plaintiff, the impairment is such that the plaintiff will suffer economic loss for the remainder of his working life. To determine the quantum of his lump sum award in respect of his economic loss represented by the reduction or elimination of his future earnings, an additional preliminary step is required in the computation, prior to the application of the discounting technique above described. This preliminary step requires the determination of the plaintiff's life expectancy or working life expectancy. Actuarial evidence should be adduced to compute the injured party's *working* life span, to derive a statistical evaluation of the injury period, which working life span will be the period over which the plaintiff suffers economic loss. It should be observed that the plaintiff suffers financial loss of potential earnings only during the period of his working life span, and that component of the total damage award should be computed with reference to this period, which will usually be shorter than his total life span. In contrast, the component of the damage award relating to his pain and suffering and loss of amenities of life should be computed over his *total* life span.

Recognition of the value of actuarial evidence in a court of law is not by any means a novel notion.[44] As early as 1880, Lord

44. One detects in some judgments and legal writings the vestige of a flight from

Blackburn observed on the utility of such evidence in computational matters:

> The Legislature has cast on the Court of Session the task of "ascertaining the value" . . . but . . . has given no directions at all as to how . . . I think the Legislature knew that the value of an expectancy must, in a great degree at least, depend on the probabilities of the duration of life, the chances of marriage, and the chances of such marriage proving fruitful. They must, I think, have known that actuaries had tables founded on extensive experience, on which they acted, which enabled them to value with considerable accuracy the probabilities of life; and that though the experience on which calculations as to the probabilities of marriage and issue were based was much narrower, and the results more subject to uncertainty, *yet that some calculation could be made in that way, and none could be made in any other.* I think, therefore, that the Legislature must have contemplated that the Court would call in the assistance of an actuary, to report to them on all those matters which properly come within the province of an actuary [emphasis added].[45]

(d). Characterization

The traditional analysis based on conceptual distinctions of the capital asset theory and the substitution ("in lieu") theory can, however, only be carried so far. When one gets to the point of *requiring*, as an implicit assumption of the computation, the plaintiff to erode his capital sum on a regular basis, which as seen above is necessary so as to compensate and not enrich the plaintiff, the distinction between capital asset and loss of earnings becomes obscure. Ultimately the capital value of any property right is the discounted present value of future cash flows emanating from that property. What is land but the profits thereof? Thus, it is submitted, that shorn of all its verbal decorations, the traditional analysis of capital asset versus loss of earnings is not sufficient to provide a satisfactory solution. For every asset may be viewed from two sides of the same coin. It may be conceived of as the capitalized value of future cash flows, and classified as a sum representing "capacity" or a capital asset; but this capital asset represents no more than the substitution of discounted future earnings. The two theories

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figures. For an excellent exposé on the misunderstanding prevalent in legal circles regarding the nature and functions of actuarial tables, see A. T. Traversi, *Actuaries and the Courts* (1955-56), 29 A.L.J. 557 at 577, where the author observes: ". . . In certain ways, there appears to be a chasm between the thinking of courts and that of actuaries in a sphere which is the peculiar province of the actuary . . . ."

45. *M'Donald* v. *M'Donald* (1879-80), 5 A.C. 519 at 539-40

condense down to different sides of the *same equation,* the capitalized value being equal to the sum of the future earnings discounted to their present value. Viewed in this light, inconsistent tax treatment of different sides of the same equation is premised on illusory and non-existent distinctions, and is reduced to an exercise in semantics, with form prevailing over substance.

These propositions may be demonstrated by mathematical formulations. Assuming an annuity contract paying a constant stream of dollars in perpetuity, equivalent to the plaintiff's loss of future earnings, and ignoring any element of risk, the capitalized value is represented by:

$$V = \frac{\$N}{i}$$

Where: V = capitalized value on discounted present value

\$N = annual receipts representing lost earnings

i = interest rate.

By summing a convergent geometric progression and writing out the discounted terms one gets:

$$\frac{\$N}{(1+i)} + \frac{\$N}{(1+i)^2} + \ldots$$

$$= -\$N + \$N \left[1 + \frac{1}{(1+i)} + \left(\frac{1}{(1+i)}\right)^2 + \ldots \right]$$

$$= -\$N + \$N \quad \frac{1}{1 - \frac{1}{1+i}} \quad = \frac{\$N}{i}$$

Here it is suggested that, in the interest of logical consistency, the fundamental characterization of "V" should retain the character of the \$N which are being discounted.

When the discussion is framed in the context of an injured plaintiff in a personal injury action, the problem is magnified in one sense, for one gets involved in the "value" of a human being or some part of a human being, *e.g.* an arm, leg, eye, *etc.*, the loss of which "value" the court endeavours to recompense in some monetary sense. Without getting involved in Aristotelian ethics, the court endeavours to recompense the injured party by two distinct elements: (i) his financial earnings forsaken or destroyed which may be classified as loss of earnings; and (ii) compensation for the loss of amenities of life, which should be referred to as capacity compensation, with "capacity" meaning the capacity to enjoy life *in his pre-injury condition.*

If this basis for judicial compensation is accepted, then, it is submitted that the first element — the loss of earnings — should be subject to taxation, in that it conforms to our operationalized and pragmatic concept of income as being an accretion to wealth and net gain in a specified period of time, with such gains being measurable, quantifiable, capable of objective determination and administrative implementation. But the second element — compensation for loss of amenities of life, which would include that portion of the award granted for pain and suffering — should be exempt from taxation in that such sums do not conform to our notions of income as operationally applied. If one viewed income as a flow of benefits as postulated by Fisher, one might be led to tax man's personal attributes that provide benefits in some economic sense, such as his good looks, character, facility for conversation, *etc.*. However, the concept of income as operationally implemented does *not* include such benefits. Since these personal amenities of life are not taxed initially, one should not tax any element of the damage award attributable to the replacement of these amenities, *e.g.* the money paid to the injured party for the loss of the use of his legs and the foregone pleasure of walking; the loss of his eyes and the forsaken pleasure of sight. This second element does not provide any accretion to wealth, in that it merely replaces the initial non-taxable "stock" or "amenities" of the individual. In contrast, the first element — loss of earnings — contributes towards the individual's wealth in substitute of that which was initially taxable and should be taxed in like manner. Issues relating to the appropriate medium and manner of taxation of the loss of earnings component are deferred to a later section of this paper.[46]

Restating the above propositions in the context of income theory, one may apply the first leg of the three-pronged test enunciated earlier. Does a personal injury damage award result in an improvement in the economic power of the individual, capable of

46. *Infra,* at 425 *et seq.*

objective measurement and quantification?[47] The answer would appear to be unequivocally in the affirmative for that portion of the total damage award which relates to the compensation for loss of actual and potential earnings. This would indicate a *prima facie* classification of the earnings component as income, subject to the reconciliation of such awards with the theory of damages on a conceptual level, and the ultimate resolution of any pragmatic, inhibiting, or restraining factors generated by the second and third prongs of the income test.[48]

III. Theory of Damages

The tax treatment of damage awards or the influence of tax factors in the determination of the quantum of such awards, must, as intimated earlier, be reconciled with some conceptual theory of damages, prior to any final resolution of the problem posited in this paper. Conceptual neglect in this area rivals that found in the realm of income theory, despite the importance of the question. As Street has suggested:

> It is believed that the crucial questions are just as frequently ones of damages, but little doctrinal discussion of that topic is carried on. Of course, liability is easier to discuss, for it lends itself to that process of conceptualization which judges find so hard to resist.[49]

With a view to facilitating the doctrinal discussion of the issues involved, the concept of damages and the judicial determination of quantum, is analyzed on a comparative basis.

The underlying principle of the theory of damages in tort actions has long been held to be, either explicitly or implicitly, compensation in the form of monetary *restitutio in integrum*. Punitive or exemplary damages are the exception to the oft cited rule of compensation. Hence, Street enunciates the above proposition by observing that

> . . . with the exception of exemplary damages, then, the function of all heads of damage is to compensate the plaintiff on the principle of *restitutio in integrum* . . . where the loss suffered is pecuniary but not capable of exact calculation the courts still accept the principle of *restitutio in integrum* . . .[50]

47. *Supra* at 396.
48. *Infra*, at 425 *et seq*.
49. *Supra*, note 2 at 43.
50. *Supra*, note 2 at 3.

A similar view was expressed by the House of Lords a century earlier, when Lord Blackburn observed:

> I do not think there is any difference of opinion as to its being a general rule that, where an injury is to be compensated by damages, in settling the sum of money to be given for reparation of damages you should as nearly as possible get at the sum of money which will put the party who has been injured, or who has suffered, in the same position as he would have been in if he had not sustained the wrong for which he is now getting his compensation or reparation.[51]

Fifty years later an identical sentiment was echoed by Viscount Dunedin, that

> . . . the common law says that the damages due either for breach of contract or for tort are damages which, so far as money can compensate, will give the injured party reparation for the wrongful act . . . .[52]

The American and Canadian views in regard to the theoretical premise of damage awards are similar. In theory at least, and apart from rare punitive damage situations, the damages awarded in personal injury actions are compensatory in character, with an objective of making good the victim's losses. The purpose, then, is to restore the injured person to the position he would have occupied had the wrongdoing not occurred, to the extent that a monetary award can accomplish this objective.[53] In Canada the judicial approach is towards "fair" rather than perfect compensation, with the jury being required to take a reasonable view of the case and give what they consider to be fair compensation.[54] Thus in *Boarelli* v. *Flannigan,* the Court observed:

> . . . It has also been said on many occasions that damages awarded in negligence cases for personal injury are not to be 'punitive', still less are they to be reward; they are to be compensatory only and these propositions are said to be applicable to both special damages as well as general damages . . . .[55]

This similarity of the theoretical foundations in all three

51. *Livingston* v. *Rawyards Coal Co.* (1879-80), 5 A.C. 25 at 39.
52. *Admiralty Commissioners* v. *S. S. Susquehanna,* [1926] A.C. 655 at 661.
53. D. B. Dobbs, *Remedies,* s. 81; C. T. McCormick, *Damages,* s. 137; *Higgins* v. *Guerin* (1952), 245 P. 2D 956 (Ariz. S.C.); 22 Am. Jur. (2d), *Damages,* s. 12, 13, 85.
54. *Sheahen* v. *Toronto Rv.,* [1911] 25 O.L.R. 310 (C.A.); *Anderson* v. *Forrester* (1914), 7 W.W.R. 1039 (Man. K.B.).
55. (1973), 36 D.L.R. (3d) 4 at 7 (Ont. C.A.).

jurisdictions extends to the structural heads under which damage awards are identified, with the initial distinction being drawn between pecuniary and non-pecuniary loss.

The pecuniary component of the damage award represents financial losses incurred as a consequence of the tortious injury of the plaintiff and may conveniently be subdivided into two principal sub-categories (a) Past Loss of Earnings and (b) Future Loss of Earnings. Each of these subdivisions of the pecuniary component is examined with a view to characterization of the damage award and its subsequent treatment in the context of income and tax theories.

1. Past Loss of Earnings

This sub-category of the pecuniary component of the total damage award represents the easiest computational segment, with minimal associations of uncertainty and conceptual confusion. In Anglo-Canadian jurisdictions the amount claimed by the plaintiff is listed under the head of special damages and represents the actual loss already suffered by the victim until the date of the trial. Where the plaintiff is paid wages or a salary, the loss of earnings up to the date of the trial can usually be determined by a simple calculation.[56]

How then should these special damages, representing the *actual* past loss of earnings be characterized? Do they represent the replacement of a capital asset, or are they "in lieu" of actual earnings lost? It is submitted that this element subscribes to the substitution theory and that the plaintiff receives what he would otherwise have received in direct remuneration. This "in lieu" or substitution of earnings theory receives judicial approval when one examines those situations where some extraneous factor occurring *in the past* may have affected the plaintiff's wages or earnings for a particular period of time. Thus, a plaintiff may have been employed in a factory which happened to be closed for a period of time for one reason or another, *e.g.* strike, lay-off, *etc.* In such cases, the plaintiff's compensation has been correspondingly reduced, not, it is submitted, for any change in his impaired condition or capacity, but rather due to the substitution effect of his lost earnings. The English Court of Appeal exhaustively reviewed the computational

56. D.A. Kemp and M.S. Kemp, *The Quantum of Damages* (3d ed. London: Sweet and Maxwell, 1967); A. Samuels, *Damages in Personal Injury Cases* (1968), 17 Int. & Comp. L.Q. 443.

mechanism applicable in these circumstances in *Phillips* v. *London & S. W. Rly.*, where Brett L.J. outlined the technique:

> Bramwell L.J. has described how the earnings of a working man ought to be dealt with. I agree with his view subject to this remark, that his description assumes that no circumstances existed which would have prevented the working man from earning the same wages during the time he was in fact disabled. If the plaintiff had resided in Lancashire and had earned his livelihood by working at the mills there, and if all the mills in Lancashire had been closed from the date of the accident, the jury would have to weigh that fact and consider whether he could have continued to earn his ordinary wages.[57]

Further, this substitutional mechanism of determination has not been altered with the passage of time, as was demonstrated by the decision in *Rouse* v. *Port of London Authority*.[58] There the plaintiff had been employed as an "A-Bookman" docker at the the time of his injury. As a result of his injury he was downgraded to a "C-Bookman", at a lower wage scale. Had the Court applied a "strict capacity" view of the plaintiff's loss, he would have received the difference between his post- and pre-injury earnings on the premise that his "capacity" had been impaired. Not so, however. Rather, the Court examined employment conditions on the docks during the tenure of the injury to determine the *substitutional* loss of earnings suffered. As Parker J. remarked:

> So far as the special damage is concerned, there are, as I have said, the thirteen weeks when he did not work at all, which is £127 19s lld. From then until June 13, after which no claim is made, he had light work on and off; and if you make a mathematical calculation, the difference between what his pre-accident rate of earnings was and what he in fact made in light work, you get a loss of £358 lls. 6d.[59]

This portion of £358 would in any view of the capacity theory represent the loss attributable to the plaintiff's impaired capacity to work as an "A-Bookman." However, the Court was not prepared to rest its computation on that premise. Rather, it went on to reduce the award on the premise of what the plaintiff would *actually* have earned had he *actually* worked. Parker J. continued:

> As against that, it is agreed that even if he had been classed, as he was originally, as an "A-Bookman", he might well not have

57. (1879), L.R. 5 C.P.D. 280 at 291 (C.A.).
58. [1953] 2 Lloyds Rep. 179 (Q.B).
59. *Id.* at 184.

> been in full employment, because conditions changed during that period in the docks, and I must make some allowance for that.[59a]

This substitutional premise of compensation is even more dramatically highlighted when one examines those situations where the plaintiff has already been compensated by his employer on a purely voluntary basis. Hence, in *Dell* v. *Vermette*[60], the Ontario High Court held that the tortfeasor was *not* liable for the plaintiff's loss of wages, since he had already been compensated for his wages by the employer on a voluntary basis. At first blush, one might be inclined to constrain the *ratio* to the premise that the defendant was not liable because the plaintiff suffered no loss. However, this view could only be supported if the wages which the plaintiff received were viewed on the basis of the substitution theory. For the fact of the plaintiff's "impaired capacity" remained a constant, whether or not his employer compensated him. Further, if the substitutionary ("in lieu") theory is rejected, and the plaintiff is held to receive his wages in return for his "impaired capacity", then such wages would logically be exempt from taxation by virtue of the *Jennings*[61] decision and the unexpressed DNR policy of non-taxation of such awards! He would then be placed in a better position financially, merely because the employer continued to pay his wages during the injury period.

While the issue of whether or not a court should consider the value of any collateral benefits received by the plaintiff has not been conclusively resolved, an examination of the cases including and excluding such benefits in the determination of quantum indicates the courts' implicit, if not explicit, adoption of the "in lieu" theory in the actual computational process. In *Moore* v. *Taylor*[62], the plaintiff suffered a whiplash injury as a result of the defendant's negligence. A wage loss of $5137 was proved, and it was further established that the plaintiff received $2185 out of an employment mutual benefit fund, the premiums of which had been contributed 50% by the plaintiff and 50% by the employer. The British Columbia Supreme Court held that there should be deducted from the plaintiff's wage loss that portion of the $2185 that had been paid by the employer, *i.e.* $1242. Wootton J. remarked: ". . . I

59a. *Id.*
60. (1963), 37 D.L.R. (2d) 101 (Ont. H.C.).
61. [1966] S.C.R. 532; 57 D.L.R. (2d) 644.
62. [1973] 3 W.W.R. 193 (B.C.S.C.).

conclude that the $2185 is part of wage loss. Therefore, of that amount the amounts of money paid by the company are paid on account of wages . . . ." As a consequence of this view, the plaintiff received $2142 from the mutual benefit fund being the *employer's* contribution, and $3895 from the defendant, giving him a total of $5137 being the *exact* amount of his established wage loss as special damages.

In contrast, in *Balla* v. *Corporate-Plan Leasing Ltd.*[63], collateral benefits were excluded in determining special damages. The *ratio,* however, supports the "in lieu" theory of damage computation. The injured plaintiff suffered a wage loss of $9132 and received $1300 under a weekly sickness and accident benefit plan. In excluding the $1300 from the computation, the Court reasoned that it was not a wage loss. As Morand J. explained:[64] ". . . I am prepared to accept that this weekly sickness and accident benefit is not in lieu of wage payments . . . . I am fixing the lost wages to the following . . . $9132 . . . ", thereby explicitly accepting that the $9132 was in lieu of lost wages.

2. *Future Loss of Earnings*

In turning from past earnings loss to the loss of future earnings, the underlying foundation remains the same. The person suffering the damage is entitled to full compensation for the financial loss suffered. The problem, however, remains: Is the plaintiff receiving his compensation for financial loss in lieu of lost earnings or his impaired earning capacity? Sir J. Holder, Attorney-General, stated in argument in the *Phillips* case:

> It is no doubt the rule that a jury must not attempt to give a man full compensation for bodily injury; if they were to do so there would be no limit to the amount of damages, for no sum would be equivalent for the loss of a man's eyes; but full compensation is to be made for pecuniary loss.[65]

James L.J. delivered the opinion of the Court with Brett and Cotton L.JJ. concurring:

> . . .[Y]ou are to consider what his income would probably have been, how long that income would probably have lasted, and you are to take into consideration all the other contingencies

63. (1973), 35 D.L.R. (3d) 360 (Ont. H.C.).
64. *Id.* at 362 - 63.
65. (1879), 5 Q.B.D. 78 at 84.

> to which a practice is liable . . . the consequences of the wrongful act here are undoubtedly that Dr. Phillips has been and is prevented from earning such a sum of money as you think he would have been likely to earn if this accident had not happened.[66]

While the above-mentioned may indicate the variables which a jury should consider, such as the earnings of the injured plaintiff, the probability of continuity of these earnings, adjusted for increases and decreases resulting from the contingencies of life, it does not provide conclusive indicia permitting of classification of damage awards into a capacity or loss of earnings dichotomy. In addition, the writings of some academics do little more than state the conclusion on some *a posteriori* determination, assuming the conclusion to be derived. Thus, Fleming suggests that such awards compensate impaired capacity and as such should be exempt from tax, by observing that ". . .[o]n a technical level, it may be supported on the ground that the basis of compensation is loss of earning capacity, a capital asset, rather than loss of earnings, a form of income . . . ."[67] On the other hand, the Kemps conclude *a posteriori* that ". . . the plaintiff is awarded compensation for prospective loss of earnings and not for loss of earning capacity, treated as a capital asset . . . ."[68]

As indicated earlier in the context of the discussion on income theory, the traditional analysis of the problem in the context of capacity (capital asset) theory versus a loss of earnings ("in lieu") theory is severely constrained by its own parameters, as observed in the remarks of Diplock L.J., in *Browning's* case, that ". . .[a] plaintiff is not entitled to damage for loss of capacity to earn money unless it is established that he would, but for his injuries, have exercised that capacity in order to earn money . . . ."[69] The resulting circularity of this approach derives from the measure of capacity itself; for the measure of capacity on one side of the equation is equal to the exercise of that capacity to earn money and represented by the prospective and past loss of earnings on the other side of the same equation. The traditional analysis carried to its ultimate has resulted in the differential treatment of damage awards

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66. *Id.* at 87.
67. J. Fleming, *Damages: Capital or Rent?* (1969), 19 U. Toronto L.J. 295 at 316.
68. *Supra,* note 56 at 24.
69. *Browning* v. *War Office,* [1963] 1 Q.B. 750 at 766 (C.A.).

for purposes of taxation, depending on which side of the *same* equation one views the award. Any conclusions derived from such an analysis would at worst be accidental and capricious, and at best fortuitous.

In order to break the tautological process inherent in the traditional analysis, it becomes imperative to dissect the mechanism of judicial determination of damage awards. Thus, while Samuels has suggested that the ". . . courts have never decided whether the basis of compensation is loss of probable actual earnings or loss of earning capacity . . . .",[70] it is submitted that an examination of the *methodology* of judicial computation reveals the nature of judicial reasoning, and suggests a dichotomy for classification of such awards.

This judicial methodology involves an initial breakdown of the award into two component elements: the pecuniary element is determined as a function of the plaintiff's loss of past and future earnings and medical expenses adjusted for the various contingencies of life; the non-pecuniary element is premised on the assumption that a plaintiff should receive compensation for his loss of the amenities of life. This initial dichotomy may be seen in the *Gourley*[71] decision itself. The respondent, a senior partner in a firm of civil engineers, was seriously injured in a railway accident for which the appellants admitted liability. In assessing the quantum of damages, the trial judge provided the following breakdown:

(i)	Actual loss of earnings	£15220
(ii)	Estimated future loss of earnings	22500
		£37720
(iii)	Out-of-pocket expenses	1000
(iv)	Pain and suffering	9000

The sole issue before the House of Lords was whether the incidence of income tax and surtax should be taken into account in assessing that part of the damages attributable to actual or prospective loss of earnings. Their Lordships were of the view that income tax factors should be accounted for, and they reduced the quantum of the award from £37,720 down to £6,695. The severity of the decision and suggestions for amelioration are discussed later in this paper.[72] For

70. Samuels, *supra,* note 56 at 444.
71. [1956] A.C. 185; [1956] 2 W.L.R. 41; [1955] 3 All E.R. 796 (H.L.).
72. *Infra* at 425.

present purposes, the rationale underlying their Lordships' decision is pertinent. Their Lordships were moved by a concern to pursue the determination of the quantum in the context of the theory of damages. In this context Earl Jowitt observed:

> . . .[T]he tribunal should award the injured party such a sum of money as will put him in the same position as he would have been if he had not sustained the injuries.[73]

Lord Goddard, in addressing the issue, commented:

> Damages which have to be paid for personal injuries are not punitive, still less are they a reward. They are simply compensation, and this is as true with regard to special damages as it is with general damages.[74]

The sum represented by £37,720 was designed to substitute that which the respondent had lost by way of past and prospective earnings, which amounts *should* have been subject to tax in the normal course of events. The non-pecuniary element of £9000 replaced the respondent's amenities of life and was treated by their Lordships in a manner similar to the treatment it *should* have ordinarily received, *i.e.* tax exempt status.[75]

An analysis of those few cases in all three jurisdictions which present a computational breakdown of damages awarded under the head of general damages reveals a judicial mechanism designed to compensate on a two-pronged basis. In the first component the court endeavours to substitute the plaintiff's loss of earnings. In the second component the tribunal seeks to replace impaired capacity, in the sense of the plaintiff's *loss of amenities of life*. Hence, in *Senior* v. *Barker & Allen Limited,* where a young boy had his right hand crushed in an industrial accident, the Court awarded £6500 in general damages. The computational mechanism is demonstrated by Lord Denning M.R.:

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73. [1956] A.C. 185 at 197; [1956] 2 W.L.R. 41 at 43; [1955] 3 All E.R. 796 at 799.

74. *Id.* at 208; [1956] 2 W.L.R. at 52; [1955] 3 All E.R. at 805.

75. The emphasis on "should" deserves explanation. In the course of litigation, the parties in *Gourley* had stipulated that the damage award would be tax-exempt, under the British Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, and would *not* have fallen within Schedule D. Hence, the *ratio* of *Gourley* is that the principle of reduction of the damage award by tax factors applies when two conditions are satisfied: (1) in calculating damages, reference is made to income which would be taxable, and (2) the sum awarded by way of damages is by law or (absent any legal ruling) by concession of the litigants based on Inland Revenue Practice, not taxable because it is deemed to represent a capital sum. This gives rise to "Gourley's Paradox" that the court should account for tax factors when Inland

> The usual practice in these courts is to take, especially with a boy of this age, a substantial number of years purchase; fifteen years' purchase at that figure would give a very substantial sum *for loss of future earnings*. It might be as much as £4000. Then, *in addition*, there is the loss of amenities; he has been deprived of the use of the hand, and has none of the amenities of life which a good hand gives. It was accepted by counsel that in these days that figure might well be in region of £2500[emphasis added].[76]

Canadian computational techniques are similar. The court endeavours to compensate the plaintiff on the same two bases as in *Goshen* v. *Larin*,[77] an action for battery on the plaintiff's person. As a consequence of the battery the plaintiff was off work and lost wages of $96 per week for twelve weeks and was awarded $1152 as special damages. In addition he obtained $700 in general damages, the Court observing that ". . . the plaintiff also suffered some pain and inconvenience for a period of two or three months and *he also lost the use of his wrist and arm for that period of time* . . . ." [emphasis added]

However, when the issue was presented to the Supreme Court of Canada in the *Jennings*[78] case, the Court circumvented the central issue of whether the award or any portion of it related to loss of earnings or impaired capacity, by assuming the conclusion. It should be observed that at trial the trial judge had dissected with rare clarity the basis of computation of the total damage award as follows:

(1)	Out of pocket expenses	$ 13,801
(2)	Loss of salary to date of trial	33,800
(3)	Additional expenses	600
(4)	Expenses of appointing committee	529
(5)	Hospital expenses for expected life	20,075
(6)	Estimated medical expenses for expected life	2,600
(7)	Estimated loss in connection with stock options	18,590
(8)	The present value of loss of salary for expected remaining life *after* deduction of tax	104,000
(9)	Loss of enjoyment of life	2,000

Revenue regards the payment as in respect of a *capital loss*, and ignore tax factors when the Inland Revenue regards the payments as income. While one appreciates their Lordships' desire to achieve compensation and avoid multiple taxation of the same proceeds, the suggested proposals of this writer at 425 *et seq.*, would eliminate the need for conceptual acrobatics.

76. [1965] 1 W.L.R. 429 at 432 (C.A.).
77. (1974), 46 D.L.R. (3d) 137 (N.S.S.C., T.D.).
78. [1966] S.C.R. 532; 57 D.L.R. (2d) 644.

The contentious issue for purposes of this discussion related to items (2) and (8). The Court concluded that income tax factors should not enter into the computation of damage awards and increased item (8) back to its pre-tax level. In reaching its decision the Court cited several pragmatic considerations for ignoring tax factors in determination of quantum[79]. However, it skirted the primary conceptual issue by assuming without discussion that the loss represented compensation for impairment of capacity. As Judson J. succinctly observed: ". . . For what it is worth, my opinion is that an award of damages for impairment of *earning capacity* would not be taxable under the Canadian Income Tax Act . . . ."[80] Thus, with remarkable brevity and without analysis of the thorny issue, the Supreme Court of Canada chose to ignore the conceptual dilemma inherent in such situations, and, as the ultimate arbiter of appeals in income tax matters, rendered a *dictum* on the possible tax treatment of such awards.

In the United States, where one might expect greater clarity in the characterization of damage award payments, due to the presence of s. 104 of the Code, the conceptual analysis is no less confused. While the presence of s. 104 of the Code has statutorily resolved one aspect of the dilemma and given definitive authority that such awards are not to be taxed by the IRS, it has not resolved the issue of whether income tax factors should be considered by the court in the determination of the quantum of the award. The general view has been that tax factors should not be taken into account by the court[81]; there are, however, enough decisions on the other side of the fence to make the issue sufficiently contentious. Hence, in *Floyd* v. *Fruit Industries*, where the Supreme Court of Connecticut had to consider the quantum of damages in a wrongful death suit, the Court, in assessing the award, observed:

> Damages for wrongful death, as such, are allowed as compensation for the destruction of the decedent's capacity to carry on life's activities, including his capacity to earn money, as he would have if he had not been killed . . . It follows that in many respects damages are assessed in the same way as in a nonfatal case involving a total and permanent destruction of capacity to carry on life's activities . . . the injury in the first

79. The pragmatic hurdles considered by the Supreme Court are evaluated, with suggested solutions at 425 *et seq*.
80. [1966] S.C.R. 532 at 544; 57 D.L.R. (2d) 644 at 655 [emphasis added].
81. 22 Am. Jur (2d), Damages, s.88, 1965; Annot. (1959), 63 A.L.R. (2d) 1393. 1398-1404, 1420-22.

> instance is as to probable *net* earnings, in the ordinary sense of that phrase as used in accounting practice, during the probable lifetime . . . there is an important factor which must be offset against probable net earnings. *That factor is any saving in income tax liability* which can properly be attributed to cessation of earned income [emphasis added].[82]

The Court went on to uphold the award on the basis of net earnings after tax as being the just, realistic, and fair rule of compensation.[83]

Again in *Montellier* v. *United States*[84], the United States Court of Appeals, Second Circuit, were content with *either* proposition — of consideration or non-consideration of tax factors in determining awards. The case involved a wrongful death action, and the Court refused to reverse on the issue of non-deduction of income taxes, observing that ". . .[i]t would not have been erroneous . . . for the trial judge to have made a deduction for income taxes, which would have amounted to a substantial sum in this case. . . ." In other situations, appeal courts have considered the issue of tax factors as an adjunct to the determination of whether an award was excessive. Hence, in *Southern Pacific Co.* v. *Guthrie*[85], the Ninth Circuit, in evaluating whether an award of $100,000 was too high, commented that

> . . . due regard for the principle of compensation required recognition that a plaintiff should not be in a better position financially than he would have been if he had continued to work, and that hence some consideration of tax deductions is proper . . .[W]e think the Court's view that the net take-home pay, after taxes, would represent the actual loss, is correct . . . .

Finally, in at least one American jurisdiction, the Court adopted a hybrid pose by accounting for tax factors on the *past* earnings component, and ignoring such considerations in assessing the loss of *future* earnings.[86]

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82. (1957), 136 A. 2d 918 at 924-25 (Conn. S.C. Errors).
83. See also *Moffa* v. *Perkins Trucking Co.* (1961), 200 F. Supp. 183 (Conn; U.S.D.C.); *DeVito* v. *United Air Lines* (1951), 98 F. Supp. 88 (N.Y.; U.S.D.C.); *Leming* v. *Oilfields Trucking Co.* (1955), 282 P.2d 23 (Cal. S.C.); Annot. (1959), 63 A.L.R. 2d 1393 at 1423 - 24.
84. (1963), 315 F. 2d 180 at 186 (U.S.C.A., 2d Cir.).
85. (1951), 186 F. 2d 926 (U.S.C.A., 9th Cir.), *cert. denied* (1951), 341 U.S. 904.
86. *Beaulieu* v. *Elliott* (1967), 434 P.2d 665 (Alaska S.C.). It is interesting to observe that the Court viewed the rationale of the "majority rule" of ignoring tax considerations as being uncertainty in determination and not any capacity theory:

> . . . For the rule — inability to predict with sufficient certainty what taxes

Underlying the judicial approach of the courts in the United States as indicated by the above cases, has been the search, as in Canada and in England, for a conceptual reconciliation of the function of damage awards to achieve compensation with the concept of net income. The task, however, has met with the same lack of success as in Canada, due in part at least to similar verbal distortions and the absence of concentration on the conceptual foundations, as illustrated by *Grant* v. *Thomas*[87]. In that case the plaintiff, a janitor, was injured in an auto accident and suffered whiplash as a consequence. As a result of the accident the plaintiff missed work for fourteen days with a loss of wages amounting to $160. The plaintiff recovered $11,000 comprised as follows:

Special Damages	
Medical	$ 135
Property	85
Past Loss of Wages	160
General Damages	
Pain & Suffering	$ 4,020
Impaired Capacity	6,600
	$11,000

Despite the victim's *full* compensation for his *full* loss of earnings and for associated pain and suffering, he received an incremental $6,600 for impaired capacity. The Supreme Court of Iowa observed that loss of earning capacity is to be measured by ". . . the present value of the loss of impairment of general earning capacity, rather than loss of wages or earnings in a specific occupation . . . ."[88] At first glance this would appear to be in direct contrast to the English view as expressed in the *Browning*[89] decision. However, further analysis of the decision reveals that while the Court was avowedly compensating "impairment of capacity", the Court's perception of "capacity" was not an economic one in the sense of the capital asset or replacement of capital theory, but rather blended in with the

would have to be paid — does not exist here, because taxes on income earned prior to trial can be easily calculated based on income tax laws and regulations as they existed at the time the wages would have been earned . . . . (673).

87. (1962), 118 N.W. 2d 545 (Iowa S.C.).
88. *Id.* at 548.
89. [1963] 1 Q.B. 750.

notion of pain and suffering and amenities of life. As the Court reasoned:

> He does not do the janitor work at the school *as well* as he did before the accident. He does not play games with the children as he did before. The children on the bus give him more trouble because he is *nervous*. He has given up Little League baseball and no longer works around the house and yard. Because of the *pain* in his neck he sometimes either walks the floor or sleeps in a chair.[90]

The Court then, in evaluating the claim of the plaintiff, and in awarding the $6,600 for impairment of capacity, is really talking of those attributes relating to the quality of life, which, traditionally, when taken from a plaintiff by a negligent defendant, are compensated through the medium of the pain and suffering or loss of amenities of life element of the award; this could equally have been achieved by awarding $10,620 for loss of amenities of life.

If, however, one examines the underlying judicial mechanism in operation in the determination of awards — quite apart from the interchangeable labels attached to the various elements — one observes in the American decisions a similarity of approach in the techniques of computation to the Canadian and English methodology. Hence, in *Kinchen* v. *Cottle,*[91] where the plaintiff was injured in an auto accident, necessitating absence from work for a period of eight weeks, he was compensated as follows:

Medical Expenses	$ 50
Pain & Suffering	1,250
Past Loss of Earnings	148
	$1,448

The past loss of earnings was increased from $100 to $148 by the appellate court on the premise that the greater sum represented "... the difference between his Workmen's Compensation rate of $32.50 and wages of $50 per week for the eight and one-half weeks ..." thereby supporting the substitutional or "in lieu" theory of compensation over and above the amount attributable to pain and suffering. So also in *Greyhound Lines Inc.* v. *Craig*[92], where the

90. (1962), 118 N.W. 2d 545 at 547.
91. (1965), 173 So. 2d 379 (Louis. C.A.; 2d Cir.)
92. (1968), 430 S.W. 2d 573 at 575 (Texas Civil C.A.).

Court of Appeals held that ". . .[i]f a plaintiff's earning capacity is not totally destroyed, but only impaired, extent of his loss can best be shown under evidence by comparing *actual* earnings before and after the injury . . . ."

The preceding analysis reveals the reckless abandon with which judicial decisions and academic literature have employed phrases such as "capacity", "earnings ability", "loss of earnings", "replacement of capital", *etc.*, as if nothing would depend on their choice. As a consequence of the resulting confusion, like a self-fulfilling prophecy little has depended on the choice of terminology, and conceptualism has been cast to the winds in this area of the law. Thus in *MacDonald* v. *Deson*[93], a decision subsequent to *Jennings,* the action involved a claim for damages by the widow of the deceased, by way of compensation for negligence causing death. The trial court assessed damages and in so doing took account of potential tax factors applicable to the deceased. The British Columbia Court of Appeal upheld the award and distinguished the *Jennings* decision with the terse comment that

> . . . this is not a case that comes within the principles enunciated by the Supreme Court of Canada . . . where the Court was considering the impaired earning *capacity* of the party injured . . . .

Rather the Court of Appeal was of the opinion that

> . . . in arriving at the net income of the deceased to which the family might be entitled in a case of this kind, the income tax payable by the deceased would have to be deducted. Had the deceased lived, the widow could not under any circumstances have been entitled to the benefits of his gross earnings without, amongst other things, the deductions of his income tax.[94]

Would Jennings, had he not been injured, have had the benefits of his gross earnings without any deductions for income tax?

The above case juxtaposed against the *Jennings* decision demonstrates the convenient elasticity of terminology such as "earning capacity" and "loss of earnings" as found in judicial usage. In *Jennings* the plaintiff was awarded $33,800 past earnings to the date of the trial, plus $104,000 anticipated loss of earnings (later increased to a pre-tax basis), over and above amounts awarded for pain and suffering, loss of amenities of life, *etc.*. The Court

93. (1970), 73 W.W.R. 241 (B.C.C.A).
94. *Id.* at 248.

characterized these sums as being amounts in lieu of earning capacity. In *MacDonald* the "capacity" of the wage earner was totally extinguished and the compensation was premised on the deceased's loss of potential earnings based on actuarial evidence indicating that he would have continued employment till age seventy. This was characterized on the "in lieu" theory as being substitution of earnings and tax factors were considered to base the award on a net earnings basis.

Other Canadian cases have similarly departed from the *Jennings ratio* with comparable facility. In *May* v. *Metro Toronto,* the Ontario High Court, in assessing the damages in a wrongful death action, felt

> . . .it is quite clear, however, that the *Jennings* case does not apply to the case at bar in any event, for the present case is not taken by the person who would be earning the income but by the person who would be receiving a benefit from the net income. It is obvious that the widow at no time was entitled to the income and at no time was she ever able to receive or could she count on receiving either as a right or as a gratuitous payment anything more than the *net* income of the deceased *after deducting income tax* . . . .[95]

The Court thus distinguished the *Jennings* decision on either (1) the basis of standing of the plaintiff and postulated a different rule where the plaintiff is the estate of the deceased, as opposed to the injured plaintiff, or (2) that the widow was not entitled to anything more than net income. The first distinction lacks any conceptual substance and is premised on mere form. The second distinction ignores the premise that the deceased *himself* would *not* have been any more entitled to gross income than his widow, and is a distinction without a difference. The issue was finally presented to the Supreme Court of Canada in *Gehrmann* v. *Lavoie,*[95a] to determine whether the *Jennings* principle was confined to non-fatal personal injury cases. A majority of the Court decided that the *Jennings* principle applied to fatal accident situations, thereby overruling the lower court decisions which had adopted a contrary view.

Insofar as the primary purpose of damage awards is compensation, both of the elements of the total damage award — pecuniary loss and loss of amenities of life — represent substitutional sums of

95. (1969), 2 D.L.R. (3d) 659 at 662 (Ont. H.C.).
95a. (1976), 59 D.L.R. (3d) 634 (S.C.C.).

money. This substitutional aspect alludes to the computational methodology in the determination of quantum, and should be extended to the subsequent conceptual characterization. The distinction, however, between the two elements, despite their similarity in being substitutionary, should lie in the *initial* dichotomy of the elements which the award seeks to replace. Whereas the pecuniary element seeks to replace that which in its original format was taxable, the element pertaining to the monetary replacement of the amenities of life substitutes for that which was initially exempt from all tax. This approach would be similar in philosophy to that suggested in *Raytheon*[96] that ". . .[a]s in other types of tort damage suits, recoveries which represent a reimbursement for lost profits would be taxable income, the proceeds of litigation which are their substitute are taxable in like manner. . . ." The question then to be asked is: In lieu of what were the damages awarded? The response suggested in this paper is that one element is awarded to replace and substitute for potential lost earnings, and should be characterized accordingly. The second component relating to the compensation for loss of amenities of life should similarly be substitutionally characterized and totally exempt from all tax implications and considerations.

Given the desired and oft stated objective of compensation in the determination of damage awards, the above recommended substitutional characterization of the two principal components, and their subsequent tax treatment in a manner similar to the treatment afforded the original elements, has the enviable attribute of enhancing conceptual purity both in the area of damage and income theory, while at the same time injecting a dose of equity into the bloodline of the tax structure. If the above substitutional characterization is accepted, the problem of implementation comes to the fore. As intimated earlier, two major alternatives present themselves for consideration. On the one hand is the *Gourley* solution of the judicial consideration of tax factors in determination of quantum, an alternative which has met with severe criticism as a result of the inherent limitations, rigour and rigidity of this approach. On the other hand is the alternative, recommended by this writer, that all tax consequences and the tax treatment of the damage award should be vested in the hands of the appropriate administrative agency, the Department of National Revenue in

96. *Raytheon Prod. Corp.* v. *Comm.* (1944), 144 F. 2d. 110 (1st Cir.), *cert. denied* (1944), 323 U.S. 779.

Canada, with suitable statutory safeguards incorporated into the taxing statute.

IV. Suggested Methodology for Taxation in Canada

In the context of the conceptual framework of the preceding analysis, and the recommendation that that element of the total damage award which corresponds to the substitution of past and future earnings, should be subject to taxation, it becomes imperative to devise a method which achieves at the same time the conceptual and equitable integration of the theories of income and damages with the pragmatic objectives of administrative convenience and simplicity. There has been a plethora of criticism of the proposition propounded in the *Gourley* decision that the court should take into account income tax factors in assessing the quantum of an award in personal injury actions. The criticism, premised on both the doctrinal and pragmatic implications of a judicial tribunal endeavouring to account for such tax factors, is in the opinion of this writer well directed. On a doctrinal level, the criticisms run the range from issues of remoteness and *res inter alios acta* to the inequity of applying progressive tax rates to bunched income receipts.[97] On a pragmatic plane, issues of flexibility of planning, uncertainty of future tax rates, foreign income problems, simplicity, the possibility of double taxation, and the added delay and expense of trials are raised by critics.[98]

If, however, one views the legal system as the totality of various sub-systems, it becomes imperative that there be an integration of the sub-systems directed towards some identified objective. Hence, the limitations of one arm of the legal system in implementing an objective should not form the rationale for rejection of the concept, but rather should suggest the possibilities of implementation through some other sub-system. The thrust of the criticisms levelled against the consideration of tax factors by judicial tribunals is thwarted in part by shifting the arena from the courts to the Department of National Revenue. In devising the proposed methodology for taxation in Canada herein outlined, the underlying objective is the desire to reconcile the conceptual necessity for the imposition of tax on that portion of the award relating to the

97. As Fleming, *supra,* note 67 at 316, puts it ". . . the most, serious objection, however, to taxing the award is that it would be intolerably punitive and inequitable under our customary, highly graduated system of taxation . . . ."

98. For a sampling see Street, *supra,* note 2; Dworkin, *supra,* note 10; Fleming,

substitution of past and future earnings, with the desirable requisite of an administratively feasible and equitable mechanism.

It is, however, the desire for equity within the taxing mechanism which raises problems in construction of the structure. For one dimension of equity is premised on the notion of the ability to pay, which implies the existence of progressive tax rates. As the Carter Commission observed:

> . . . [W]e believe that taxes are fair when they are allocated according to ability to pay, and that this would be achieved by the application of a progressive rate structure to the annual tax base . . . .[99]

However, the very existence of the progressive tax rate structure, designed as an instrument to promote equity, may become the sword of inequity when indiscriminately applied. It should be remembered that the choice of a calendar year as a time interval for the basis of computation of tax liabilities for an individual is an artificial creation, divorced from any conceptual understanding of income, designed to enhance simplicity and administrative feasibility at the expense of a sacrifice in equity. Hence, the Carter Commission commented that

> . . . there is nothing sacrosanct about the measurement of income for tax purposes on an annual basis. The choice of the calendar year as the relevant time period is a matter of convention and convenience rather than principle. . . .[100]

Once again we are posed with the dilemma — How much of a sacrifice is required in the conceptual purity of an idea or an ideal tax structure, in order to achieve greater simplicity and administrative convenience? Again, it is worthy of repetition that the answer should remain that only that much sacrifice should be made as is absolutely necessary to make the proposal operationally feasible. At opposing ends of the spectrum there is the inherent and inevitable conflict between pure equity and pure simplicity. Pure equity would necessitate the spreading out of an individual's income over his entire tax life, with the consequent administrative problems for both the Department of National Revenue and the taxpayer. Pure simplicity, on the other hand, would dictate that any sum be taxed in the year of receipt, with the resultant inequitable consequences. The

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supra, note 67; G. Bale, *British Transport Commission v. Gourley, Reconsidered* (1966), 44 Can. B. Rev. 66.

99. 3 Carter Report, *supra,* note 13 at 242.

100. *Id.* at 241.

severity of this inequity was crystallized in *Gourley*[101], where, as a consequence of the House of Lords' decision to consider tax factors in the determination of quantum, the earnings component of the award was reduced from £37,720 to £6695.

The total benefit derived by a taxpayer permitted to spread his income over any period of time is the cumulative sum of two separate and distinct influences: (i) mitigation of the rigour of progressive tax rates, and (ii) the time value of money. The impact of the progressive rate composition as embodied in s. 117 of the *Income Tax Act*[102] together with the provincial levies may be demonstrated by a hypothetical case. Assume an individual receives (a) $15,000 taxable income for each of five years, or (b) $75,000 in the first year and zero dollars in the next four years. The resulting tax liability of the individual taxpayer is shown below:

CASE A		
Annual Income		$15,000
Tax thereon:		
On the first $14,000	$3,415	
On the next 1,000 (@ 35%)	350	
Federal Tax Payable	$3,765	
Provincial Tax @ 36%	1,355	
Total Tax Payable per year	$5,120	
Total Tax Liability over five years		$25,600
CASE B		
Lump Sum Income		$75,000
Tax thereon:		
On the first $60,000	$21,795	
On the next $15,000 (@ 47%)	7,050	
Federal Tax Payable	$28,845	
Provincial Tax @ 36%	10,384	
Tax Liability over five years		$39,229

101. [1956] A.C. 185; [1956] 2 W.L.R. 41; [1955] 3 All E.R. 796 (H.L.).
102. S.C. 1970-71-72, c. 63.

Here, two individual taxpayers in identical tax circumstances, with identical *total* incomes over the same total time span, will have a difference in their respective tax liabilities of $13,629 over the five year period, with the difference being attributable *entirely* to the progressive rate factor.

In addition, however, where a taxpayer is permitted to spread his income received in any year over several future years, he receives an incremental, but distinct, benefit from the time value of money. Hence, if the individual in Case B were allowed to spread his income of $75,000 received in the first year in the same manner as the individual in Case A, he would receive an *additional* benefit equivalent to the *net* after tax interest earned on the money invested for the five year period.

Given this important disparity between the tax liability of those taxpayers who receive their income over several taxation years and those who might receive their income lump sum in one year, it becomes imperative to design some system of taxation of the earnings component of a personal injury award which will achieve *relative equity* and at the same time maintain *relative simplicity* and be administratively operational. It is worthy of note that this inherent conflict between equity and simplicity is not limited by any means to the area of damage awards compensating for lost earnings. Indeed, identical problems arise whenever *any* form of bunched income is received, which reflects an accretion to wealth accumulated over several taxation years. As the Carter Commission observed in this context:

> . . . in particular, we believe that substantial gifts and inheritances, damage payments, and property gains realized or deemed to have been realized on death or cessation of Canadian residence all require relieving provisions. . . .[103]

In the spirit of the preceding discussion outlining the desirability of conceptualism reconciled with equity and simplicity, the following specific proposals are submitted as a possible mode of DNR taxation of the earnings component of damage awards. They suggest the tenor of possible tax treatment, and are intended as such, rather than as a definitive resolution of the problems outlined.

(1) The concept of income should be enlarged to bring within its embrace that portion of the damage award which represents a

103. 3 Carter Report, *supra*, note 13 at 242.

substitution of past and future earnings. This may be achieved in one of two ways:

(a) by a shift in judicial attitude interpreting this segment of the damage award as being encompassed within the concept of income as that term is currently employed in the *Income Tax Act*. Thus, the judicial interpretation of "income" and "taxable income" as used in ss. 2, 5, 6, and 9 may be expanded to encompass such payments. However, given the *dictum* of the *Jennings* decision[104], interpreting such amounts as representing compensation of impaired earning capacity, and the judicial role of the Supreme Court of Canada as the ultimate arbiter of income tax appeals, such a judicial shift represents at best an equivocal possibility.

(b) by express statutory inclusion within the *Income Tax Act*, an unequivocal assault may be launched on the problem, with the attendant advantages of clarity and certainty. To achieve this, s. 56 (1) may be expanded by insertion of a new paragraph 56(1) (s) as follows:

Amounts to be included in income for year
56(1) [Current] Without restricting the generality of section 3, there shall be included in computing the income of a taxpayer for a taxation year,

. . .

(s) *Damage Payments* [Proposed]

(i) All payments received by a taxpayer as a result of settlement or litigation, representing that portion of a damage award in a personal injury action which relates to the compensation of past or future earnings, howsoever computed, but so as to exclude any portion of the award whether by settlement or litigation, that relates to compensation for pain and suffering and loss of amenities of life.[105]

(ii) Proof of allocation between amounts to be included or excluded may be made by extracts of any relevant

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104. [1966] S.C.R. 532 at 545; 57 D.L.R. (2d) 644 at 655; Judson J., adopting the minority view of *Gourley*: ". . . In a case of personal injuries, what the plaintiff has lost is the whole or part, as the case may be, of his natural capital equipment . . . .".

105. The tax treatment of medical expenses is considered *infra* in proposal #3. It is submitted that existing provisions contained in s. 81 (1) (g.l), (g.2), (g.3) and 81 (4) be eliminated from the Act as being unduly preferential to infants. The concern, as expressed by the Minister of Finance, for victims of thalidomide would appear

> documents, including judicial records used in, or resulting from, the settlement of or litigation involving the personal injury action. In the absence of any specific documentation, the allocation made by the taxpayer between amounts to be included or excluded by s. 56(1)(s)(i) must be reasonable.

The inclusion of a statutory amendment as outlined above will, in addition to the obvious conceptual benefits, have associated with it several ancillary pragmatic advantages: (a) since only amounts actually *received* by the plaintiff would need to be included, it would make moot the criticisms that ". . .[t]ax is not a charge on income before it is received . . . ."[106], and would have no impact on the taxpayer pending any appeal; (b) it would thwart any possibility of double taxation, since the courts should no longer feel the necessity to consider income tax factors in determining quantum, in the knowledge that the plaintiff's tax liability would be determined by statute[107]; (c) the courts would be relieved from any overtones of uncertainty and speculations in regard to future tax rates, personal exemptions, foreign income, and the individual circumstances peculiar to every taxpayer[108]; (d) at the same time the dangers of prolonging trials to evaluate and consider such technical arguments would no longer be necessary[109]; (e) finally, the presence of such statutory provisions would serve as an inducement to the judiciary, upon pressure by counsel, to clearly articulate the characterization and computation of damage awards, with the resulting benefits to future potential litigants in settling claims.

On a doctrinal level the advantages of statutory inclusion are even more impressive. A persistent criticism of the *Gourley* doctrine has

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misdirected in that a substantial portion of such awards would represent the loss of amenities of life and would be exempt under the proposals suggested herein.

106. Comment of the English Law Reform Committee, *supra*, note 9 at 4 and adopted by Judson J. in *Jennings*, [1966] S.C.R. 532 at 543; 57 D.L.R. (2d) 644 at 655.

107. Dworkin, *supra*, note 10 at 323.

108. *Id.* at 324; "The *Gourley* calculation is inconvenient speculation and often seriously wrong . . . ." Also dissent by Lord Keith of Avonholm in *Gourley* at 811 ". . . To fix on an estimate of future taxation is impossible, and to assess them *de futuro* on the basis of existing taxation without any knowledge of what the future commitments and obligations and personal status of the injured person will be, or would have been, seems to me unreal . . . ." The force of these and similar criticisms would be eliminated substantially.

109. The fear of complex tax issues were expressed in *Highshew* v. *Kushto* (1956), 134 N.E. 2d 555 at 556 (Ind. S.C.):

> . . . such subject matter would involve intricate instructions on tax and non-tax liabilities with all the regulations pertinent thereto. No Court could with any certainty properly instruct a jury without a tax expert at its side . . . .

been the inevitable by-product effect of providing the defendant with a windfall related to the plaintiff's tax status. On the other hand, the *Jennings* doctrine places the windfall on the plaintiff. As Fleming has commented, ". . . in effect, the pre-tax rule gives a windfall to the plaintiff, the post-tax rule to the defendant . . . ."[110] In light of the earlier doctrinal discussion on the purpose of damage awards, the granting of a windfall to *either* the plaintiff or the defendant erodes the fundamental theory of damages, and should, where possible, be avoided. The treatment suggested above succeeds in this objective by placing on the tortfeasor the full burden of his negligence, while restoring the victim of the tort to his pre-injury position. As a consequence, this proposal should dissipate any fears of enrichment of either party to the action at the expense of the other.

Further, the suggested statutory inclusion mitigates the public policy exceptions taken by some critics. It has been argued that the *Gourley* principle may result in a significant invasion of the privacy of the plaintiff, in that accurate judicial consideration of tax factors would necessitate the introduction of personal information into an open court, which may prove distasteful to the plaintiff.[111] Where, however, the relevant amount is administered through the medium of a taxing statute, the plaintiff retains his privacy without the necessity of disclosure of personal financial information.

(2) Advocates of non-taxation of damage awards have long taken the stance that the fact of escalating legal fees may in certain instances be quite substantial, and have used this crutch to support the view that the plaintiff has suffered enough by the payment of these fees, and as such should not be further penalized by deductions pertaining to income tax elements [112]. Thus, in *McWeeney* v. *New York, NH & HRR Company,* the Court alluded to this rationale in the following terms:

> Whatever the reasons of history or policy for the American practice of generally not awarding attorneys' fees to the

110. Fleming, *supra,* note 67 at 317; see also a similar view by Bale, *supra,* note 98.

111. Dworkin, *supra,* note 10 at 326:

> . . . The charge that the *Gourley* principle may result in a significant invasion of the privacy of the plaintiff may sound sensational, but it is not necessarily inaccurate . . . .

112. Fleming, *supra,* note 67 at 318 has expressed the fear that in some cases ". . . a lion's share of the award is devoured by the plaintiff's own lawyer . . . ."

> successful party . . . we can hardly shut our eyes to this when asked to require the jury to take another extrinisic factor into account — particularly when we know that even court-prescribed maximum scales of contingent fees, which have been attacked by counsel as inadequate, provide either a sliding scale ranging from 50% down to 25%.[113]

In part this rationale is peculiarly American, since in the United States there is no indemnity for litigation costs. In contrast, the English practice permits a successful plaintiff to recover from the loser *all* reasonable costs, whereas the usual Canadian practice is to allow partial indemnity for costs to the successful party. Upon any view, however, it is difficult to conceive of a more diluted justification for exemption of the *entire* damage award from taxation, particularly in Canadian jurisdictions, which allow for partial indemnity of costs.

Rather, the approach suggested herein is that legal fees incurred in the course of litigation or settlement of personal injury claims should be made specifically deductible by appropriate statutory amendment. Several alternative routes are available to implement this suggestion.

(a) In light of s. 8(1)(a) of the *Income Tax Act,* which restricts the employment expense deduction to 3 per cent of income from employment, with an annual upper limit of $150, the deduction of legal fees may be restricted in a similar manner as being an expense incurred to recover lost employment income. From any realistic standpoint, however, the $150 limitation on the deductibility of legal fees, while achieving consistency, would be all but useless to the successful plaintiff.

(b) The $150 maximum could be raised in the case of deductibility of legal fees in personal injury actions to an equivalent of $150 times the number of years which the damage award is intended to recompense. Hence, where the award is for lost earnings for a period of ten years, the upper limit would be $1,500; where the intended compensation covers life, then presumably the same life expectancy computation as that used at trial could be utilized. Once again, this technique suffers from any realistic relationship to current legal costs.

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113. (1960), 282 F. 2d 34 at 38 (U.S.C.A.; 2d Cir.).

(c) The entire *proportional* amount expended in legal fees, less any legal costs specifically recovered, *i.e. proportional* net legal fees, could be made deductible from that portion of the damage award being subjected to taxation. Proportional deductibility may be supported on the premise that of the total award only the portion relating to lost earnings is being subjected to taxation, with the pain and suffering and loss of amenities of life component being treated as exempt receipts. The advantage of this approach is that it relates the deductibility of an expense to the corresponding inclusion of income, and is in closer harmony with the concept of *net* income. Thus, where a plaintiff receives a total award of $100,000 made up of:

Lost earnings	$60,000
Medical expenses	5,000
Loss of amenities of life	35,000

with attendant legal costs of $15,000 of which $5,000 is recovered from the defendant as party and party costs, then the deduction of legal fees would be restricted to a maximum of $6,000.[114]

(d) The *entire* amount of any *net* legal fees and disbursements may be made deductible from that component of the total damage award which is being subjected to taxation. In the illustration above, the entire legal fees of $10,000 would be deductible from the $60,000 lost earnings component. The argument in favour of this approach is that the high cost of legal costs should not unduly penalize the injured plaintiff.

While the selection of either (c) or (d) as the appropriate technique for the allowance of deduction of legal fees is a matter of relative equities, this writer favours the last-mentioned alternative for the reason above-mentioned. To implement this suggestion, a new paragraph 60(s) may be enacted to read as follows:

Other Deductions

60. [Current] There may be deducted in computing a taxpayer's

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114. $\frac{\$\ 60{,}000}{\$100{,}000} = 60\% \times (\$15{,}000 - 5{,}000) = \$6{,}000.$

income for a taxation year such of the following amounts as are applicable:

. . .

(s) [Proposed] Such amounts *paid* by the taxpayer in respect of legal fees and associated legal disbursements incurred in the settlement or litigation of a personal injury action, less any portion of legal fees and associated legal disbursements *received* by the taxpayer from another party as a result of settlement or litigation of such action, but so as *not to exceed* the amount attributable to the compensation of past or future earnings, included in income in s. 56(1)(s)(i).

Several observations in respect of the proposed statutory amendment are in order. The proposal is intended to ameliorate against the inclusion of the earnings component into income, so as to generate taxation on some concept of *net* income, with a matching of revenues and related expenses. As such the overall deductibility is restricted to a maximum amount equal to the amount included in income. Further, the deduction is restricted to the *net* legal costs only in those situations where the taxpayer actually *receives* his costs from the defendant. Where, as in certain contingency fee arrangements, the recovered costs are retained by legal counsel, the taxpayer's deduction would be the gross legal fees and costs *actually paid* by him[115].

(3) It is suggested that medical expenses be treated as a "wash" transaction. Since *proposed* s. 56(1)(s)(i) makes no reference to medical expenses recovered to be included in income, and *existing* s.110(7) has the effect of prohibiting a deduction for medical expenses where the taxpayer has been or is entitled to be reimbursed, such expenses incurred and reimbursed would in effect "wash". This approach would accord with the concept of income, since there would be no accretion to wealth. Further, if the taxpayer has, prior to receiving his damage award by judgment or settlement, deducted his medical expenses incurred under s.110(1)(c), the Minister may obtain a waiver under s.152(4) for subsequent reassessment.

The impact of the proposals to this juncture may be illustrated by the use of hypothetical figures. Assume that Taxpayer A has recovered a personal injury damage judgment of $100,000 plus costs as follows:

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115. It may be observed that the tortfeasor will *not* be able to deduct his legal fees

Lost Earnings (Past)	$ 10,000
Lost Earnings (Future)	55,000
Loss of Amenities of Life	35,000
	100,000

and has expended $15,000 in legal fees and costs, of which $5,000 were recovered from the defendant. Then he would be required to include in income:

Lost Earnings (Past)	$10,000
Lost Earnings (Future)	55,000
	$65,000

from which $65,000 he could deduct $10,000 net in legal fees and costs, leaving him with net income of $55,000. How should the $55,000 be taxed?

(4) As observed earlier, the existence of progressive tax rates within the structure of the taxing statute, inserted as a vehicle of equity, may prove instrumental in achieving inequitable and harsh results. To mitigate against the rigour of such severe consequences, which results ensue whenever bunched income is taxed lump-sum in one taxation year, the taxpayer should be allowed to "forward average" his residue of $55,000 by use of a forward-averaging annuity contract. The forward-averaging provisions *currently* in the Act are designed to permit individual taxpayers to spread their income and the resultant tax liability over a number of future years. The use of the forward-averaging mechanism to spread the plaintiff's income over future years achieves at the same time the desirable equitable consequence of permitting the taxpayer some measure of relief, and is administratively feasible and simple in view of the existing provisions in the Act. The mechanism for deferral of certain forms of income (which list excludes damages) is currently accomplished by the purchase of an "income averaging annuity contract", pursuant to s.61(1)(a) and (4), whereby the taxpayer purchases with a single payment within the taxation year or within sixty days from the end of the taxation year, an annuity contract from certain licensed institutions.[116]

under this provision, since he will not have any offset income by virtue of the restriction in the proposed subsection.

116. *Income Tax Act.* S.C. 1970-71-72, c. 63, s. 61(4)(b)(i).

The essence of the forward-averaging provisions is that the taxpayer may deduct from his income the premium required to purchase the annuity contract, less the equivalent of one year's annuity receipt expected from the contract. The annuity itself must be for a guaranteed term or for the life of the individual, with or without a guaranteed term[117], with the restrictive proviso that the guaranteed term must not exceed fifteen years, or if the individual is age 71 or more at the time the annuity payments commence, the guaranteed term cannot extend beyond the year that the individual will, if alive, become 85 years of age[118]. Other restrictive conditions require that payments under the contract to the taxpayer must not commence later than ten months after the date that the individual has made the single payment for the contract[119], and the annuity payments must be equal, and must be made annually or at more frequent periodic intervals[120].

In the context of the previous illustration the plaintiff could, *if the suggested amendments were implemented,* utilize his $55,000 to purchase an annuity contract in accordance with the above specified conditions. If he expected to receive annual payments of $5,300 for fifteen years under the contract, he would be eligible to deduct $49,700 from his income in the year the contract was purchased, *i.e.* $55,000 single premium less $5,300 annual receipt expected. The taxpayer could, of course, utilize any lesser sum of the total $55,000 to purchase the annuity contract. The liability for tax is then deferred; when the annuity payments are received by the plaintiff under the income averaging annuity contract purchased for forward-averaging, the payments would be included in computing the income of the individual in the year of receipt[121]. Further, the deduction normally permitted for the capital element of an annuity payment is expressly prohibited in the case of an annuity payment under an income averaging annuity contract[122], and this would conceptually accord with the entire principal and interest elements of the substitutional loss of earnings being taxed as and when received by the plaintiff taxpayer.

Finally, it is suggested that in the selection of a discount rate by

117. *Id.*, s. 61 (4)(b)(ii).
118. *Id.*, s. 61 (4)(b)(ii)(A).
119. *Id.*, s. 61 (4)(b)(ii).
120. *Id.*, s. 61 (4) (b) (iii) (b).
121. *Id.*, s. 56 (1)(d).
122. Section 60 (a).

the court for the purpose of determination of quantum, the pre-tax discount rate is to be preferred over the after-tax. Selection of a pre-tax discount rate circumvents the necessity of the court's determining the appropriate tax rate to be applied to the plaintiff, which may fluctuate over the time span of the injury period. Further, application of a pre-tax discount rate permits the plaintiff to decide whether he will pay tax lump sum on the damage award or spread his award over a period of years through the mechanism of an annuity contract. The determination of this choice will in turn affect the effective marginal rate applicable, and should be left to the recipient of the award, rather than to a judicial tribunal.

Implementation of the suggested proposal could conveniently be achieved by statutory expansion of *existing* s.61 by the insertion of a new paragraph s.61(2)(h), structured to meet the stated objectives:

> 61 . . . .
>
> (2). . . .
>
> (h). [Proposed] Any amount included in computing the individual's income for the year by virtue of s.56(1)(s)(i), less any amounts deducted from income under s.60(s). . . .

V. Conclusion

The tenor of this paper has hinted at the vacuum of conceptualism in the evaluation of tax consequences on personal injury awards. Lord Atkin's comment made in 1925 that the law of damages still awaits a scientific statement and that this branch of the law is less guided by authority laying down definite principles than any other branch is probably equally applicable today.[123] Further, it is submitted that the absence of conceptualism in the area of damages is shadowed by the void of conceptual integration of the rationale underlying the theory of income and the objectives of a tax structure. As a consequence of this neglect, these legal compartments have, in the absence of integration, developed at tangents within a supposedly unified legal system.

The proposals submitted in this paper have endeavoured to balance the conceptual necessity of subjecting the earnings component of damage awards to taxation, with the desire to devise a scheme which would be administratively efficient and simple and still retain an equitable flavour. A decision to tax the earnings

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123. *The Susquehanna*, [1925] P.196 at 210 (C.A.).

component of such awards would reconcile and integrate the concept of income as an accretion to wealth, with the underlying objective of compensation in assessing damages. Given the decision to tax, of the two alternatives available, taxation through the medium of the *Income Tax Act* would prove superior on both doctrinal and pragmatic levels to the alternative of judicial consideration of tax factors in assessing quantum.

Statutory taxation and administration by the DNR removes at once the doctrinal hurdle of choosing between enriching the defendant or the plaintiff. Under this method neither party is enriched at the expense of the other. Rather, the defendant pays his full quota of compensation, while the plaintiff proceeds in his usual relationship with the taxing authorities. At the same time all issues of remoteness, *res inter alios acta,* and the potential for invasion of fiscal privacy become moot. On a pragmatic level, the suggested proposals prove advantageous. They permit the plaintiff to retain a measure of flexibility in arranging his financial affairs, avoid any delay and the associated incremental costs of extended trials, and provide for a more comprehensive consideration of the plaintiff's personal circumstances, exemptions, personal deductions, foreign income, and the like.

Administratively the choice of statutory taxation provides a convenient and relatively simple mechanism, with the proposals premised on the utilization of *existing* provisions of the Act with minor modifications. Further, and perhaps of pre-eminent importance, the proposals facilitate taxation of the plaintiff on some relatively equitable basis, in that they permit of income spreading over several years and the deduction of legal costs. Finally, the suggested proposals permit the taxpayer to maintain flexibility in planning his affairs, by extending the use of forward averaging contracts.

While this paper has confined itself to the narrow issue of the tax treatment of damage awards in personal injury cases, the underlying approach is of wider application. Notwithstanding the desirability and importance of conceptualism and integration of legal sub-systems, some sacrifice of these ideals to the pragmatic pressures of daily administration is inevitable. That such sacrifices should be restricted to the minimum essential for the implementation of a conceptually integrated rationale, is of general application to other areas of the law. This balancing of conceptualism against pragmatism is a task familiar to the judicial and legislative process and assumes increasing importance in a complex interactive society. In the neglect of these principles lies the germ of discord and the potential for pragmatism by default. The proposals outlined in this paper are not intended as exhaustive of all possible alternatives, and do not lay claim to any such pretence. In any balancing process requiring a compromise of conflicting considerations, value judgments and ideological influences are ever present. Rather, the proposals are intended to furnish a tenor for any future review of the problems discussed, and should be regarded as merely directional in the search for a resolution.